

## ANALYSIS

# The Eurosystem's two-tier system for remunerating excess liquidity holdings

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As a part of the broad monetary policy stimulus package introduced at its September meeting, the Governing Council of the ECB decided to introduce a two-tier system for reserve remuneration. The goal of the system is to support the transmission of monetary policy through banks to firms and households by lowering banks' costs caused by negative interest rates. The system applies as of the seventh maintenance period of 2019 starting on 30 October 2019.



Banks deposit funds with the central bank to fulfil their minimum reserve requirements, to transfer payments among each other and to safely store their assets.<sup>1</sup> The Eurosystem pays a remuneration rate on the minimum reserve requirements equal to the main refinancing

operations rate, which is currently 0%. Funds that exceed the minimum reserve requirements either remain on the banks' central bank accounts as excess reserves or are deposited overnight with the Eurosystem through the deposit facility. In the negative interest rate environment, both of these options have so far been remunerated with the ECB's deposit facility rate, which is currently -0.5%.

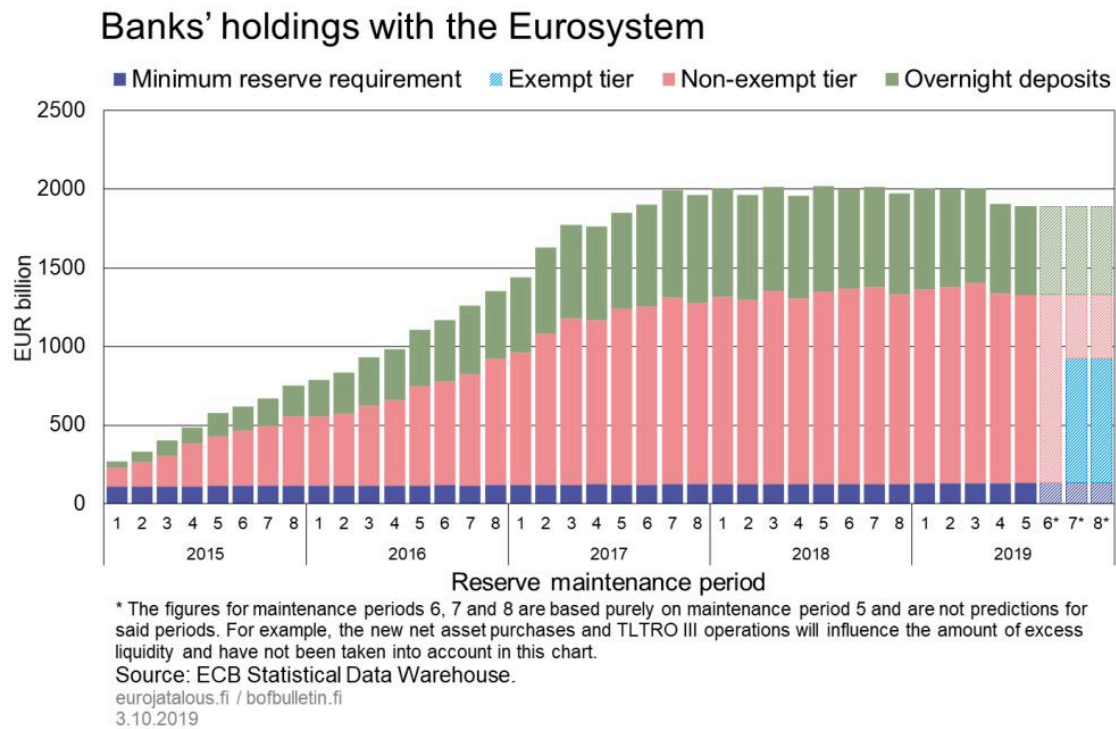
The total amount of excess reserves and overnight deposits held with the Eurosystem is called 'excess liquidity in the banking system'.<sup>2</sup> Excess liquidity has increased substantially due to the non-standard monetary policy measures implemented by the Eurosystem. The primary reason for the increase lies in asset purchases, which are financed by crediting the central bank account of the selling bank. Since the deposit rate is negative, banks are currently required to pay for their excess liquidity held with the Eurosystem, generating expenditure for the banks.

The two-tier system for remunerating excess liquidity holdings will reduce these costs.<sup>3</sup> The system aims to prevent a situation where low interest rates no longer pass on to the interest rates on bank lending due to narrowing net interest margins. Banks' net interest margins are narrowed when they refrain from passing on the negative rates to their retail deposits.<sup>4</sup> The euro area financial system remains very bank-oriented, which is why the reflection of low interest rates on bank lending rates is important for the transmission of monetary policy.<sup>5</sup>

In the new scheme, the excess reserves of each bank are divided into two tiers. The threshold level of the first tier, the exempt tier, is six times the minimum reserve requirement for that bank, and excess reserves up to this level are remunerated at zero per cent. Excess reserves beyond this level will be remunerated at the ECB's deposit facility rate. The two-tier system creates a difference between excess reserves and overnight deposits, since only excess reserves can be exempt from the negative deposit facility rate. Overnight deposits will continue to be remunerated at the ECB's deposit facility rate.

Chart 1 is an illustration of the effects on the euro area of the two-tier system for reserve remuneration. In the fifth maintenance period of 2019, the minimum reserve requirements of euro area banks amounted to EUR 132 billion. If banks' minimum reserve requirements remain at the same level, the threshold for excess reserves exempt from the negative rates will be set at EUR 792 billion. If the banking system, in turn, utilises the exempt tier to its full capacity, the excess liquidity affected by the negative deposit facility rate would be reduced to around EUR 1 000 billion.

Chart 1.



Multi-tiered deposit rates are not a new phenomenon around the world, with central banks in, for example, Switzerland, Japan and Denmark having relied on corresponding systems for many years. In practice, all these schemes are designed to exempt a part of the banks' central bank reserves from negative interest rates, thereby ensuring that the low interest rates are passed on to the bank lending rates. In fact, in Switzerland and Japan, the central banks introduced the systems immediately after adopting negative rates in January 2015 and February 2016, respectively. The Danish system was in use even before the introduction of negative rates, due to Denmark's fixed exchange rate policy.<sup>6</sup> Notice, however, that Denmark's central bank also tripled the total limit of higher-rate deposits at the same time it lowered the interest rate on one-week certificates of deposit below zero in July 2012.<sup>7</sup>

Excess liquidity is not evenly distributed in the euro area, but rather concentrated in countries with higher credit ratings, such as Germany, the Netherlands, France, Finland and Luxembourg<sup>8</sup>. Furthermore, excess liquidity is also unevenly distributed across different banks within individual countries. As the two-tier system for reserve remuneration is introduced, some banks will not use the exempt tier to its full capacity, whereas other banks will still be required to hold large amounts of excess liquidity with the Eurosystem at a negative rate. Banks will presumably even out the under-usage of the exempt tiers, which could, in principle, raise money market rates.

This is, however, not necessarily the outcome. Firstly, in efficient markets, money market rates should be determined by the marginal cost of liquidity rather than the average cost. The marginal cost of liquidity will continue to be determined by the ECB's deposit facility rate. Secondly, in the new scheme, the amount of excess liquidity affected by the negative interest rates will remain at around EUR 1 000 billion, and restarting the net asset purchases in November will increase this amount even further. Historically, with this level of excess liquidity, unsecured money market interest rates in the euro area have closely followed the ECB's deposit facility rate. Thirdly and most importantly, the Governing Council of the ECB has announced that it is prepared to adjust the parameters of the tiering system in order to ensure the effective transmission of changes in policy rates to market rates.<sup>9</sup> In other words, if money market rates begin to rise, the Governing Council could respond by, for example, lowering the threshold level for the exempt tier from the negative deposit facility rate. And if necessary, the Governing Council can also raise the threshold or the rate at which the exempted reserves are remunerated.

According to Philip Lane, Member of the Executive Board of the ECB, the aim of the two-tier system is to strike a balance between two goals: the system should offset the direct costs of negative interest rates on banks, thereby helping to sustain the pass-through of low policy rates to bank lending rates; at the same time, it should preserve the positive contribution of negative rates to the Eurosystem's accommodative monetary policy stance. In this way, the two-tier system for reserve remuneration, along with the other monetary policy instruments, provides the best support in the pursuit of the price stability objective of the Eurosystem.

## Footnotes

1. Euro area banks are required to hold a certain amount of funds as reserves in their current accounts at their national central bank. These are called minimum reserves. A bank's minimum reserve requirement is set for about six-week periods called maintenance periods. The level is calculated on the basis of the bank's balance sheet prior to the start of the maintenance period. ↑
2. Excess liquidity simply refers to all funds deposited with central banks exceeding the minimum reserve requirements. More specifically, excess liquidity is calculated as  $\text{reserve holdings} - \text{minimum reserve requirements} + \text{overnight deposits} - \text{marginal lending}$ . ↑
3. See ECB press release about the two-tier system for remunerating excess liquidity holdings. ↑
4. The net interest margin is the difference between interest income and interest expenses. ↑
5. Read more about the pass-through of negative interest rates in the feature

- article: Slightly negative central bank interest rates ease financial conditions. ↑
6. The purpose of the Danish system is to reduce banks' ability to speculate on the foreign exchange market by limiting the amount of central bank deposits available for immediate use. See web page of Danmarks Nationalbank, viewed 24 September 2019. ↑
  7. See Danmarks Nationalbank's press release about the interest rate reduction, 5 July 2012. ↑
  8. During the debt crisis, excess liquidity was concentrated in these countries, primarily because bank deposits flew to safety to banks in countries with higher credit ratings. After the crisis, however, concentration has also been driven by other factors, such as the asset purchase programme. A large share of the assets in the programme are purchased from banking groups whose head institution is domiciled outside the euro area. These banks, in turn, typically keep their central bank accounts in euro area countries with high credit ratings. Furthermore, the opportunity cost of excess liquidity is lower for banks in countries with higher credit ratings, since the interest rates on these countries' domestic sovereign bonds are lower than the interest rates on the sovereign bonds of lower-rated countries. See ECB (2017). ↑
  9. See "Reflections on monetary policy", Philip Lane 16 September 2019. ↑

## Key words

euro area, monetary policy, negative interest rate, non-standard monetary policy, tiering