Balance sheet risks in monetary policy implementation

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Monetary policy implementation in recent years has largely centred on asset purchase programmes and long-term refinancing operations. As a result, the balance sheets of the Eurosystem national central banks have grown significantly, while balance sheet risks related to monetary policy implementation have increased.

Risks incurred by private sector entities can move into the balance sheets of the public sector by various means, especially during financial crises which threaten to destabilise the financial markets. Because central bank balance sheets have grown, it is worth examining which share of the risks related to monetary policy implementation are carried by the Bank of Finland in its own balance sheet, and how these risks are mitigated and managed.

Large-scale asset purchases are subject to interest rate risk and credit risk, while refinancing operations are exposed to the risk of counterparty default. Risks related to asset purchases are managed by limiting the financial instruments eligible for purchase and by diversifying risk with issuer and issue share limits. As for risks related to refinancing operations, central bank loans to counterparty banks are always collateralised. Collateral eligibility criteria and risk management procedures have become important factors in the transmission of monetary policy during the coronavirus pandemic. In addition to pledging collateral for central bank funding, all counterparties to the Eurosystem's monetary policy must satisfy general eligibility criteria.

Public sector purchase programmes are implemented nationally, i.e. each national central bank carries out the majority of purchases of bonds issued by their respective sovereign and general government. The national central banks are individually responsible for bearing potential losses realised in these purchases. At the end of July

2020 the Bank of Finland held about EUR 30 billion of Finnish government and government-related bonds purchased under the public sector purchase programme. This comprises about one-quarter of Finland's national debt.

Under *private sector purchase programmes* potentially realised risks are shared by the Eurosystem. For example, the Eurosystem's corporate sector purchase programme stood at EUR 220 billion at the end of June 2020.[1] If an issuer were to default on a bond, the share of the credit loss to be absorbed by the Bank of Finland would be 1.84%, as determined by Finland's capital key, which is based on the relative size of the economy and population.

The Eurosystem takes advantage of specialisation in carrying out its corporate sector programmes. For example, the Bank of Finland has long experience in investing in the corporate bond market and is one of six euro area national central banks tasked with purchasing corporate bonds on behalf of the entire Eurosystem.

If a *counterparty defaulted on a monetary policy credit operation*, the Bank of Finland could realise its loan collateral. It follows that realising losses on a financing operation not only requires that the counterparty bank default but requires insufficient collateral as well. Risks related to central bank credit operations are shared by the Eurosystem as a whole, with the exception of loans under national additional credit claim frameworks. The first line of defence in monetary policy risk management thus consists of: the eligibility analysis of financial instruments that are to be purchased under monetary policy purchase programmes and the limit framework; the eligibility assessment of monetary policy counterparties; and the eligibility, adequacy and valuation analysis of collateral for monetary policy credit operations.

Exchange rate fluctuations expose the Bank of Finland to exchange rate risk. To mitigate this, the Bank of Finland balance sheet includes revaluation accounts and reserves, which rise and fall with exchange rate movements.

Tags

COVID-19, central banks, balance sheet risk, balance sheet, monetary policy