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MACROCOSM

# ECB's Operation Twist-and-Nudge

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**New collateral rules push ABS onto the balance sheet instead of sovereigns.**

Yesterday the European Central Bank announced changes to the haircuts it puts on collateral used for its liquidity operations. We recently highlighted how collateral usage has developed during the debt crisis (see "ECB: It Takes Whatever" May 22, 2013), an organic evolution in which banks have changed the collateral used based on their own needs. But with yesterday's announcement the ECB is trying to influence the collateral that banks will use.

- The ECB has increased haircuts on lower-rated sovereign and sub-sovereign instruments, and reduced haircuts on instruments that should more directly influence credit creation by banks (please see the table below).

**ECB announced changes in collateral haircuts**

| Maturity | Sovereign | | Regional | | Covered | | Uncovered | | ABS | |
|---|---|---|---|---|---|---|---|---|---|---|
| | AAA A- | BBB+ BBB- | AAA A- | BBB+ BBB- | AAA A- | BBB+ BBB- | AAA A- | BBB+ BBB- | AAA A- | BBB+ BBB-* |
| 0>1 | None | +0.5% | None | +1.0% | -0.5% | None | None | -2.0% | -6.0% | New |
| 1>3 | -0.5% | +0.5% | -1.0% | -0.5% | -1.0% | -3.0% | None | -3.0% | -6.0% | New |
| 3>5 | -1.0% | +1.5% | -1.0% | None | -2.0% | -3.0% | None | -4.0% | -6.0% | New |
| 5>7 | -1.0% | +2.0% | -1.0% | -2.0% | -2.0% | -2.0% | None | -2.5% | -6.0% | New |
| 7>10 | -1.0% | +2.5% | -1.0% | -1.0% | -2.5% | -2.0% | None | -2.0% | -6.0% | New |
| 10+ | -0.5% | +2.5% | +0.5% | +2.5% | -2.0% | -2.0% | None | -2.0% | -6.0% | New |

* BBB-rated ABS not eligible collateral previously, introduced with 22% haircut.
Source: ECB, TrendMacro calculations

This move by the ECB has two important characteristics.

- **Twist:** The ECB states that the changes will have a neutral effect on the amount of collateral available. So it should not increase the total *amount* of liquidity, but instead change *which instruments* banks are using to access that liquidity -- making it relatively more attractive for banks to hold loan-backed securities.
- **Nudge:** The collateral policy changes show a clear intention from the ECB to move banks away from the sovereign carry trade, and

**Update to strategic view**

**ECB, EUROPE MACRO, EUROPE BONDS:** The ECB announced changes to the haircuts it makes on collateral used for its liquidity program yesterday -- raising haircuts on lower-rated sovereigns, and lowering haircuts on asset backed securities. These changes -- though small -- point to an ongoing shift of focus at the ECB. It is moving from sovereign crisis prevention to measures that will encourage credit creation in the euro area. This means that from the ECB's standpoint, the sovereign crisis is over and credit growth is the biggest risk facing the euro area. We see no reason to disagree.

[Strategy Dashboard home]

instead encourage them towards credit growth. By reducing the haircuts on asset backed securities, the ECB is providing banks with access to increased liquidity for that credit.

We do not see this as a threat to sovereign debt. The only sovereigns that will be disadvantaged are those of lower-rated nations -- Spain and Italy.

- The only reason that the ECB would feel comfortable doing this is that it believes -- as we do -- that the sovereign crisis is mostly over in the euro area (see "SpanDax" July 12, 2013).

The new collateral policies build on a theme we have been highlighting for a while (see "The EIB, Not the ECB" April 12, 2013). The ECB reiterated its commitment to examining ways to support small and medium enterprise (SME) loan-backed ABS that carry a guarantee, saying,

> "Besides the adjustments to the risk control framework, the ECB will continue to investigate how to catalyse recent initiatives by European institutions to improve funding conditions for Small and Medium-sized Enterprises (SMEs), in particular as regards the possible acceptance of SME linked ABS guaranteed mezzanine tranches as Eurosystem collateral in line with established guarantee policies."

We do not mean to overstate the significance of these events by themselves -- the changes in haircuts are generally small. But they do show the ECB's *intent*, and *that* is significant. And it's the best the ECB can do now, ahead of the German elections in September, while the conservative Bundesbank will try to block more aggressive initiatives (see "Bundesblock" June 19, 2013). But that will pass. The fact remains that the ECB is turning its focus toward credit creation, and the collateral moves announced -- plus the commitment to examine ways to further enhance support for SME lending -- mean this policy focus will be the trend to watch in the coming months.

## Bottom line

The ECB announced changes to the haircuts it makes on collateral used for its liquidity program yesterday -- raising haircuts on lower-rated sovereigns, and lowering haircuts on asset backed securities. These changes -- though small -- point to an ongoing shift of focus at the ECB. It is moving from sovereign crisis prevention to measures that will encourage credit creation in the euro area. This means that from the ECB's standpoint, the sovereign crisis is over and credit growth is the biggest risk facing the euro area. We see no reason to disagree.

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