European Rates Watch

Will the ECB adjust its corridor?

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Key takeaways

- The ECB may consider adjusting the spread between its key rates
- We believe this may imply a widening of the MLF rate relative to the refi rate to 50bp
- Any change may be made to incentivise banks to improve their liquidity and funding, and not a signal of even more tightening

A corridor with three rates

The European Central Bank (ECB) may consider adjusting the spread between its policy rates: the deposit facility (depo) rate, the main refinancing operation (refi) rate, and the marginal lending facility (MLF) rate. The depo rate is the overnight (o/n) rate banks receive by placing reserves at the central bank's deposit facility, and acts as the floor of the corridor. The refi and MLF rates are the rates at which banks can borrow from the central bank for a week and overnight, respectively. Historically, the refi rate has been the de facto ceiling for the overnight indexed swap (OIS) rate (Exhibit 1).

Increasing the MLF-refi spread...

The current MLF-refi spread is 25bp and refi-depo spread is 50bp. An asymmetry between the two spreads has existed since 2015 when the ECB cut the depo rate to even more negative territory (Exhibit 2). From the standpoint of normalisation towards historical spreads in a positive rate environment, we believe any adjustments are likely to widen the MLF-refi spread closer to 50bp, rather than refi-depo closer to 25bp. Intuitively, we believe it means the ECB will be looking to deter banks from excessively using the MLF, which is the last resort of o/n funds.

... is easier than reducing the refi-depo spread

The case for adjusting the refi-depo spread closer to 25bp may be built on a shift towards a corridor system while limiting the risk of front-end rates volatility as excess liquidity declines, or to make refi operations a more attractive form of liquidity access by reducing the associated carry for banks. But one complication is timing. Such an adjustment will probably need to be made in the ECB's last hike, in which only the depo rate would be raised. If this were not the case, then the MLF and refi rate will need to be cut later. That could give a potentially undesirable signal of rate cuts.

Past MLF usage mainly in very stressed periods

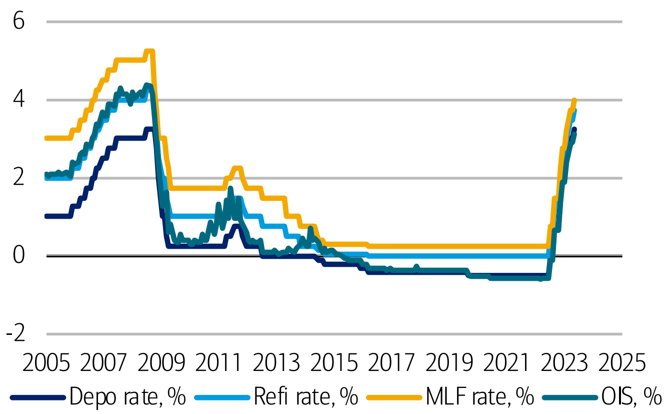
The high borrowing cost from the MLF means past usage has been low, with the highest usage being during the global financial and sovereign debt crisis (Exhibit 3). As a share of euro area bank balance sheet, past MLF usage rarely exceeded 0.01% outside of stress periods (Exhibit 4). Compared with the refi and (targeted) longer-term refinancing operations ((T)LTROs), MLF as a source of bank funding has been very low (Exhibit 5).

(Continued overleaf)

Any impact may be notable when excess liquidity is lower

Excess liquidity will decline on TLTRO roll off and quantitative tightening (Exhibit 6). Growing reserve scarcity may increase the likelihood of some banks relying more on the MLF. This may put upward pressure on front-end rates if banks start to use the MLF in meaningful size. We believe the ECB may consider raising the MLF-refi spread to further incentivise such banks to strengthen their funding and liquidity profile. We do not think a larger MLF-refi spread would be used as a signal or tool of monetary tightening. Any decision to change the spread is likely to be contingent on the ECB's operational framework review due to be concluded by end-2023 (see Liquid Insight, 1 March 2023).

Exhibit 1: OIS and the ECB's corridor
The refi rate has been the de-facto ceiling



Source: BofA Global Research, ECB

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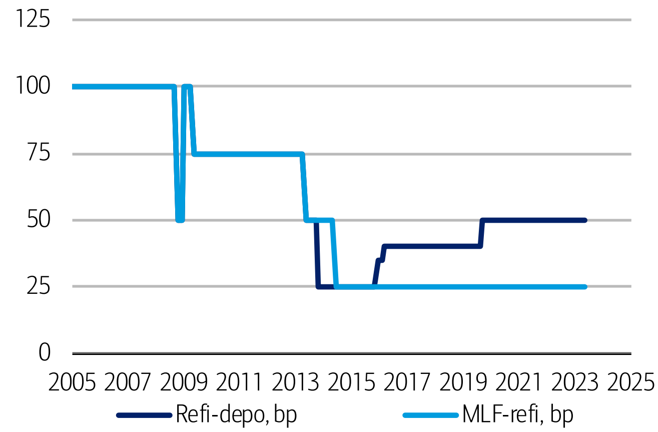
Exhibit 2: Spread between MLF and refi, and refi and depo
Asymmetry has existed since 2015



Source: BofA Global Research, ECB

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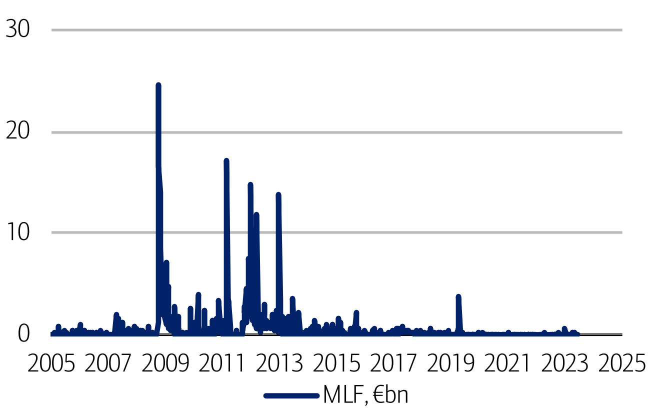
Exhibit 3: Historical MLF usage
Highest usage during global financial and sovereign debt crisis



Source: ECB

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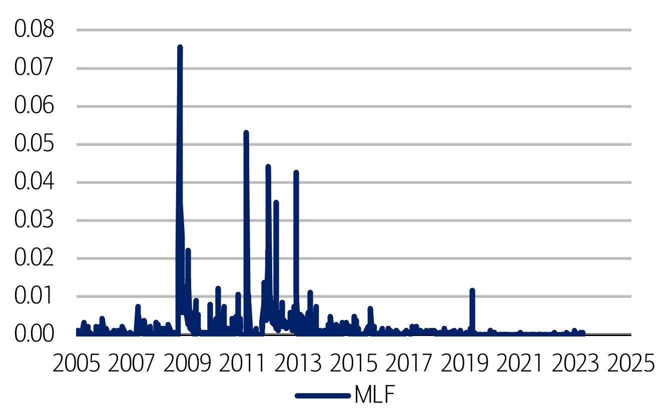
Exhibit 4: MLF, % of euro area bank balance sheet
Usage has historically been less than 0.01% of bank balance sheet



Source: BofA Global Research, ECB

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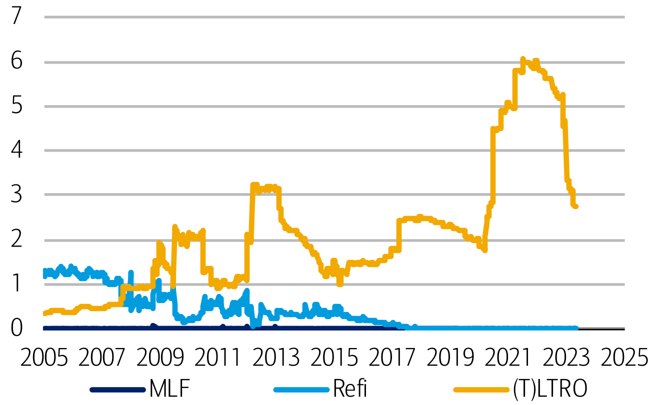
Exhibit 5: MLF, refi, and (T)LTRO, % of euro area bank balance sheet
Usage of MLF is very low vs refi and (T)LTRO



Source: BofA Global Research, ECB

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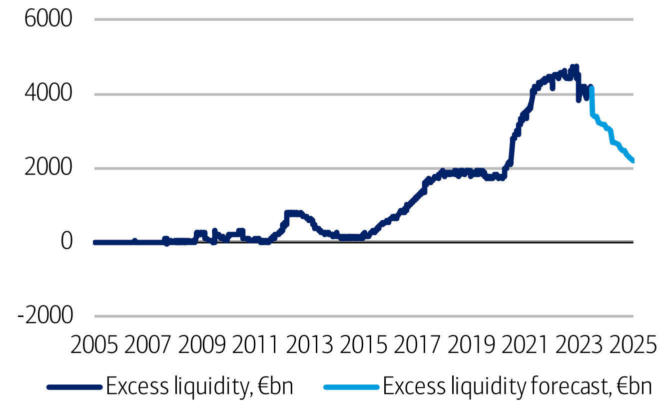
Exhibit 6: Excess liquidity in euro area
Decline in excess liquidity may increase some banks' MLF usage



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