ARTICLE – Banks need to have more active liquidity management

Banks need to adapt to an environment where central bank liquidity decreases as the Riksbank reduces its asset holdings. This places greater demands on banks to redistribute liquidity more efficiently among themselves. However, the banks that are the Riksbank's monetary policy counterparties choose to hold a liquidity buffer in the form of central bank reserves instead of placing all the liquidity surplus in certificates or using the overnight market. Many of them have also never participated in the overnight market. This suggests that banks have insufficient incentives to redistribute liquidity in the overnight market and that there may be frictions affecting banks' liquidity management. It is important for interest-rate management that the banks utilise the overnight market and use the Riksbank's instruments for liquidity provision as intended. Banks should also feel free to use the Riksbank's standing facilities - they are there to be used when needed.

Banks' liquidity management is too passive

The operational framework should contribute to effective liquidity management

The Riksbank's operational framework for the implementation of monetary policy is based on steering the short-term market rate towards the policy rate. To do so, the Riksbank mainly uses standing facilities and various types of market operations.

The Riksbank conducts weekly market operations at the policy rate. When the banking system has a structural liquidity surplus, the banks that are monetary policy counterparties can place central bank liquidity in reserves and certificates.[58] If banks do not place all the liquidity surplus in certificates, a surplus of reserves remains. If the banking system instead has a structural deficit, the Riksbank provides reserves via monetary policy repos or lending against collateral. The aim is to balance the liquidity position of the banking system so that reserves are close to zero during the term of the certificate or repo, and to signal the level of interest rates that should be established in the short-term market in Swedish krona.

[58] Reserves are the banks' money placed as overnight deposits at the Riksbank (account-held means of payment), and certificates are the Riksbank's issued transferable securities, normally with a term of one week, which can be converted into reserves. Central bank liquidity surplus refers to total reserves and certificates. For more information, see Counterparties | Sveriges Riksbank and The Riksbank's monetary policy operational framework - overall description.

The Riksbank's standing facilities allow banks to place or borrow an unlimited amount of reserves with an overnight maturity at a deposit rate 10 basis points below the policy rate or a lending rate 10 basis points above.[59] The difference between the deposit and lending rate is known as the interest-rate corridor.

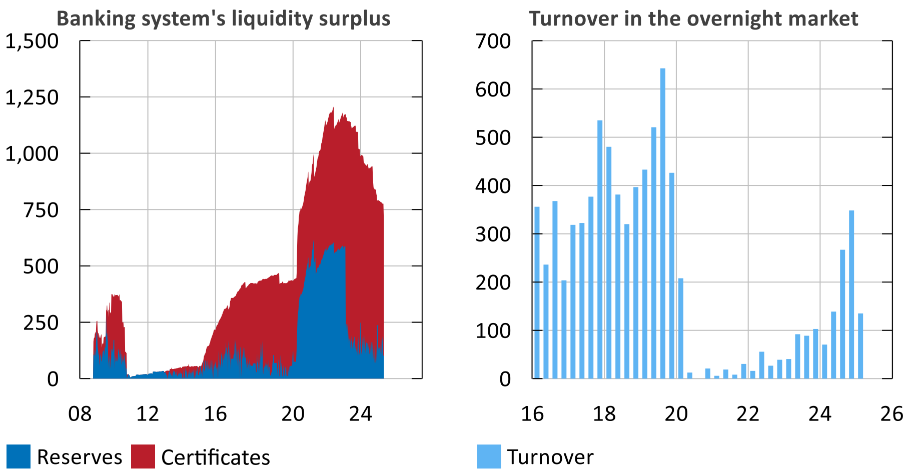
The idea is that the interest-rate corridor will create incentives for banks to balance surpluses or deficits among themselves as far as possible in the overnight market, as they can offer each other more attractive interest rates. The interest-rate corridor should therefore be wide enough to incentivise banks to borrow from each other in the overnight market. In this way, the overnight rate can end up close to the decided level of the policy rate at the centre of the corridor. If the overnight rate fulfils its function as an anchor for longer-term interest rates, the level of the policy rate propagates through the economy.

Incentives for market-based liquidity management are too weak

Between 2015 and 2022, the Riksbank injected large amounts of liquidity into the banking system.[60] This means that the banking system has had a structural liquidity surplus vis-à-vis the Riksbank for some time (see chart 27, left).

Chart 27. The banking system’s liquidity surplus and overnight money market activity

SEK billion



Note. Turnover in the overnight market refers to volumes of unsecured overnight loans in Swedish kronor between monetary policy counterparties.

Source: The Riksbank.

[59] In practice, monetary policy counterparties' surpluses in the RIX system are automatically converted into placements in the deposit facility at the end of the day, while an end-of-day deficit is interpreted as a request to borrow in the standing lending facility. Reserves are borrowed against eligible collateral.

[60] This took place partly through the Riksbank's purchases of Swedish securities, which was a complementary monetary policy measure known as quantitative easing (QE), and partly as a result of the Riksbank self-financing its foreign exchange reserves with Swedish kronor since January 2021. Both of these have been financed by the Riksbank borrowing Swedish kronor from the banks.

Over the same period, the number of monetary policy counterparties increased from 15 to 29 banks. The increase has mainly consisted of smaller banks. This means that most counterparties have only been counterparties when the system has had structural liquidity surplus. Since 2020, 14 of them have never participated in the overnight market. In addition, 9 counterparties currently have no collateral with the Riksbank, and 14 counterparties have never borrowed in the Riksbank's lending facility. This means that these banks do not have active liquidity management but only place in the Riksbank in the form of certificates and reserves.

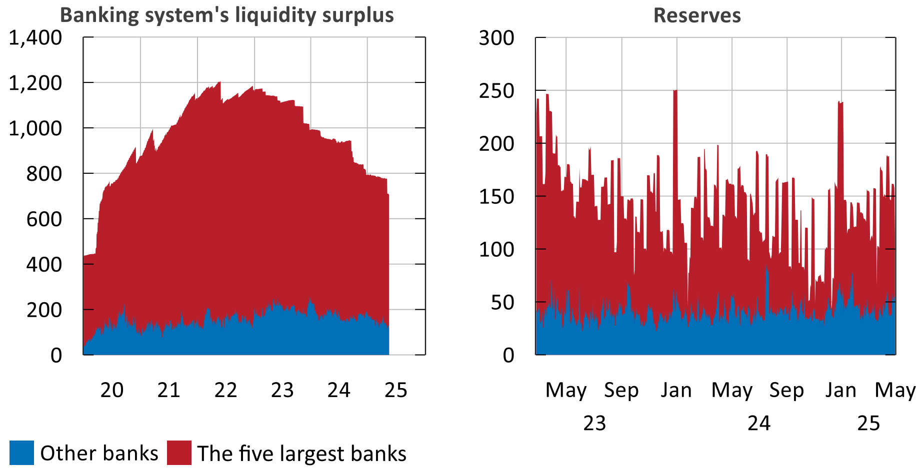
Banks' demand for certificates and reserves has fluctuated over the period (see chart 27, left). Between 2015 and 2019, the banking sector had between 1 and 175 billion in reserves. During the coronavirus pandemic, the Riksbank limited the volume of certificates offered, forcing banks to increase their placements in reserves. At that point, overnight market activity also declined rapidly (see chart 27, right). Since 2023, banks have once again been able to place all the structural liquidity surplus in certificates. Yet the reserves still amount to between 50 and 250 billion. While activity in the overnight market has increased slightly since 2023, it remains low. The amount of available reserves thus affects banks' need to utilise the overnight market.

So banks choose to hold a liquidity buffer in the form of central bank reserves instead of also placing these in certificates and obtaining a higher interest rate or using the overnight market, as intended.

The liquidity surplus is unevenly distributed among banks

The five largest banks hold around 80 per cent of the banking system's current liquidity surplus (see chart 28, left). The Riksbank is now reducing the structural liquidity surplus through quantitative tightening (QT), where the Riksbank sells securities or allows them to mature. So far, liquidity has declined mainly for the five largest banks, while it has remained broadly unchanged for the other banks (see chart 28, left and right). This indicates that the smaller banks are passive in terms of both the choice between placing in certificates or reserves and participating in the overnight market. Therefore, it is mainly the liquidity management of the five largest banks that determines activity in the overnight market. However, as the liquidity surplus in the banking system diminishes, there will be greater demands on all banks, large and small, to be active and contribute to effective redistribution of reserves.

Chart 28. The liquidity surplus and reserves distributed among banks
SEK billion



Note. The banking system's liquidity surplus vis-à-vis the Riksbank is the sum of reserves and certificates. The five largest banks are also the five largest monetary policy counterparties.

Source: The Riksbank.

Why do banks choose to hold central bank reserves?

If a bank were to experience a sudden liquidity deficit, it could borrow reserves from other banks in the overnight market. It can also use eligible collateral, including Riksbank certificates, to borrow reserves in the Riksbank's standing overnight lending facility. If the bank has certificates, it can also sell them back to the Riksbank to convert the certificates into reserves.[61] However, banks largely opt out of these options and instead hold reserves as buffers. This suggests that the incentives for market-based liquidity management are either too weak, that there are frictions in banks' daily liquidity management, or that both these factors are in play. This may be due to a number of reasons.

Opportunity cost may be too low

Banks' retention of a surplus of reserves may be due to the fact that the opportunity cost - in the form of the interest-rate corridor - is too low, i.e. the cost of 10 basis points that a bank incurs by placing central bank liquidity as reserves compared with placing it in certificates. If it is too small, it does not contribute to an effective redistribution of liquidity.

Some banks are reluctant to use the Riksbank's lending facility

There are a number of banks that state that they do not want to use the Riksbank's standing lending facility or sell back certificates because they are concerned that

[61] When certificates are resold to the Riksbank, the bank receives the reserves on the next bank day. If, on the other hand, the bank uses the certificates as collateral for loans in the standing lending facility, it receives the reserves on the same day.

other banks will perceive this as a sign of weakness. This in turn affects banks' willingness to lend reserves in the overnight market, as they do not want to risk running a deficit.

Operational capacity of several banks is lacking

Several banks lack the operational capacity to participate actively in the overnight market and to use the Riksbank's monetary policy instruments. For these banks, it may be rational to hold reserves at the Riksbank. But if an individual bank hoards reserves, it creates problems for the system as a whole because the reserves are then not distributed efficiently to the banks that need them at the time. This in turn can lead to undesirable volatility in interest-rate setting in short-term markets. By improving their operational capabilities, banks can help prevent volatility in short-term market rates.

Banks need to contribute to efficient liquidity redistribution and interest-rate setting in the overnight market

Banks that are monetary policy counterparties need to adapt to an environment of reduced structural liquidity surplus by taking an active part in efficient and market-oriented liquidity management. Banks should endeavour to manage their liquidity balancing among themselves, but it is essential that they, if necessary and to maintain market functioning, should be able to use the Riksbank's lending facility unhindered to obtain reserves. This is how the operating framework is meant to work, and it should not be constrained by stigma.

The liquidity surplus will still be significant after the end of quantitative tightening. However, this does not mean that all banks have access to the amount of reserves they need for their daily liquidity management. Banks therefore need to have the expertise and infrastructure, including limits vis-a-vis other banks, to be able to borrow and lend reserves in the overnight market.

As monetary policy counterparties, the banks need to be able to pledge collateral and borrow reserves from the Riksbank, and release reserves by selling certificates back to the Riksbank. Here, the Riksbank can require them to participate in test transactions to regularly test and ensure that they are able to do provide collateral and borrow reserves from the Riksbank.[62] The Riksbank can also promote activity in the overnight market by ensuring that the opportunity cost of money is sufficiently high.

[62] In its consultation "Transitioning to repo led operating framework", the Bank of England emphasises that requiring its counterparties to participate in regular test transactions is an important tool to ensure the operational capacity of counterparties to use its facilities.