# Eurozone

## ECB: The PSPP parameters

**■ At the ECB's September monetary policy meeting, M. Draghi announced the creation of committees "to evaluate the options that ensure a smooth implementation of [the] purchase programme."**

**■ In the current configuration, the public sector purchase programme (PSPP) parameters hinder the smooth implementation of the quantitative easing (QE), especially if, as we forecast, it is extended at least through September 2017.**

**■ There are three possible options, which could potentially be used in combination. Yet each presents its own problems.**

At the ECB's September monetary policy meeting, Mr. Draghi announced the creation of committees "to evaluate the options that ensure a smooth implementation of our purchase programme." Concretely, this means determining which parameters of the public sector purchase programme (PSPP) should be modified to face up to the potential shortage of public securities (notably German).

**The four constituent programmes of QE**

The ECB's quantitative easing programme actually comprises four distinct programmes:

- Asset Backed Securities Purchase Programme (ABSPP)
- Covered Bonds Purchase Programme (CBPP)
- Corporate Sector Purchase Programme (CSPP)
- Public Sector Purchase Programme (PSPP)

Since April 2016, the ECB, in association with the national central banks, has been making average monthly securities purchases of EUR 80bn. These purchases are subject to highly seasonal fluctuations that affect both their composition and actual purchase volumes, but since March[1] the average breakdown has been as follows:

- EUR 0.5bn for ABSPP
- EUR 3bn for CBPP
- EUR 6.5bn for CSPP
- EUR 70bn for PSPP

PSPP accounts for the lion's share of quantitative easing. Special rules apply. This notably concern risk sharing. For the other three constituent programmes, the ECB purchases the securities, and the risks are fully shared. For PSPP, the ECB conducts 20% of purchases – which corresponds to the risk-shared part – and the remaining 80% of purchases are made by the national central banks, without risk sharing.

Of the PSPP purchases conducted by the ECB (20% of the total), half is comprised of the bonds of supranational issuers (EFSF, EIB, ESM, etc.). This corresponds to 10% of PSPP. If the monthly

[1] For CSPP, our reference date is June since that is the month the programme began.

**PSPP**

In Green, purchases made by the ECB

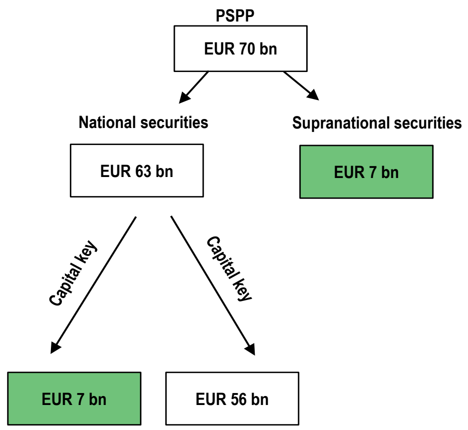


**Chart** Sources: ECB, BNP Paribas

purchase volume of the PSPP is considered to be EUR 70bn, then EUR 7bn corresponds to supranational bonds purchased by the ECB. The remaining EUR 63bn corresponds to purchases of debt instruments issued by public administrations (sovereign, regional and local entities) and agencies[2] (EUR 7bn purchased by the ECB and EUR 56bn by the national central banks) (see chart).

In addition to the minimum credit rating requirement, PSPP purchases are subject to specific eligibility criteria. There are three criteria:

- Eligible securities must have a residual maturity of between 2 and 30 years
- The yield on eligible securities must be higher than the deposit facility rate (currently -0.40%)
- The Eurosystem (i.e. the ECB and the national central banks) cannot hold more than 33% of a bond issued by a national authority and 50% of a bond issued by a supranational authority.

A fourth rule applies for the portion of PSPP concerning the acquisition of national public debt:

- Purchases must be divided geographically between member countries on the basis of the ECB's capital key.

Excluding Greece, which is not (yet) part of the quantitative easing programme, the capital key rule implies that Germany's share should reach 26.3%, France, 20.7% and Italy 18%, etc. (see table).

[2] *The ECB establishes the list of national and supranational agencies eligible for QE. See: https://www.ecb.europa.eu/mopo/implement/omt/html/pspp.en.html*

**Modifying the parameters to enable QE to continue**

The parameters of the PSPP (which the ECB itself imposed for political reasons) will hamper the implementation of the asset purchase programme, especially if, as we forecast, the programme is extended at least through September 2017. Germany's case poses the biggest problem, although it is not the only one.

Assuming that the monthly purchase volume of PSPP is EUR 70bn, the Bundesbank and the ECB must jointly purchase EUR 16.6bn in bonds issued by German public sector issuers each month. Through March 2017, this would amount to EUR 116bn from now (now is August). If the programme is extended to September 2017, then EUR 216bn would be needed. It is also hard to imagine that the ECB would suddenly stop its net purchases overnight. The programme is more likely to taper off with a gradual reduction in purchases. If tapering began in October 2017 with purchases reduced at a pace of EUR 10bn a month, then the programme would continue to run through April 2018. Assuming there is a proportional reduction in the four contingent programmes of QE, the total amount of German public sector and agency debt to purchase would total EUR 273bn from now.

Given the current level of German yields, about EUR 175bn in government bonds are now eligible for PSPP[3]. To this, we must add regional and local government bonds, which amount to about EUR 250bn in Germany, or EUR 83bn in potential securities purchases. Lastly, German public agencies account for about EUR 45bn in eligible bonds. All in all, the universe of eligible German securities is roughly EUR 300bn, from which we must remove EUR 238bn in German public debt already held by the Eurosystem at the end of August. In the end, only EUR 62bn is still available, the equivalent to less than four months of purchases[4]. Lastly, it is also worth noting that the net supply of German government bonds is negative, which tends to further narrow the purchasing horizon.

Some flexibility already exists with respect to the PSPP parameters: the ECB allows national central banks that are having trouble purchasing sufficient bonds in their jurisdiction to buy supranational securities in substitute. But this is within a limit of 10% of PSPP purchases devoted to the acquisition of supranational bonds each month. That will not suffice.

**The options**

Clearly, the parameters of the PSPP need to be changed, which is why the ECB created the relevant committees. There are three possible options[5], all of which could be used in combination.

*The ECB could increase the issuer limit from 33% to 50%.* A priori this would increase the universe of eligible German bonds by about EUR 150bn. Yet a higher issue limit could not be applied to sovereign bonds issued after 1 January 2013, because they incorporate collective action clause (CAC): if the ECB held more than 33%, it would be in a position to block any restructuring in case of default, which it would probably do in the light of the prohibition of monetary financing. This would create market distortion.

## Capital Key distribution (EUR bn)

| | Paid-up capital | (%) | Theoretical monthly purchases for a EUR 70bn PSPP |
|---|---|---|---|
| Germany | 1 948 | 26,3% | 16,6 |
| France | 1 535 | 20,7% | 13,1 |
| Italy | 1 333 | 18,0% | 11,3 |
| Spain | 957 | 12,9% | 8,1 |
| Netherlands | 433 | 5,9% | 3,7 |
| Belgium | 268 | 3,6% | 2,3 |
| Austria | 213 | 2,9% | 1,8 |
| Portugal | 189 | 2,6% | 1,6 |
| Finland | 136 | 1,8% | 1,2 |
| Ireland | 126 | 1,7% | 1,1 |
| Slovakia | 84 | 1,1% | 0,7 |
| Lituania | 45 | 0,6% | 0,4 |
| Slovenia | 37 | 0,5% | 0,3 |
| Latvia | 31 | 0,4% | 0,3 |
| Luxembourg | 22 | 0,3% | 0,2 |
| Estonia | 21 | 0,3% | 0,2 |
| Cyprus | 16 | 0,2% | 0,1 |
| Maltea | 7 | 0,1% | 0,1 |
| **Total** | **7 400** | **100%** | **63,0** |

**Table** Sources: ECB, BNP Paribas

*The ECB could abandon the deposit rate floor.* This would make numerous German government bonds eligible again, but, to calculate the exact amount, we would have to take into account the share of these securities already held by the ECB (purchased before the decline in yields made them ineligible). To circumvent this problem, let us consider the total amount of German government bonds with a maturity of between 2 and 30 years, regardless of yield: they amount to about EUR 940bn. If we apply the 33% limit, the universe of eligible sovereign securities is EUR 310 bn. This has to be compared with a total of EUR 511bn of German debt (sovereign, sub-sovereign and agency) that needs to be purchased from the beginning (March 2015) to the end (assuming QE is extended until September 2017 and tapered off thereafter). Clearly, this option would have to be combined with an increase in the purchase limits to 50% to ensure the smooth implementation of QE through the end of the programme.

The main problem with abandoning the deposit rate floor is the losses incurred on some operations for the ECB. Indeed, purchasing securities with a lower yield than the deposit facility rate would mean the ECB is paying for liquidity.

*The ECB could change the current capital key rule.* A major deviation from, or even the elimination of the capital key, would surely be the most effective option for ensuring the smooth implementation of QE. It would also enable better transmission of monetary policy by targeting the countries most in need of accommodating financing conditions. Yet, it is also the most politically sensitive option, which *a priori* means that any modifications would be reduced to the smallest possible deviations. For example, once one country reaches its limit, the ECB could distribute the remainder to be purchased among the other member countries, but still taking into account their weight within the ECB's capital key.

[3] *In early July, just after the Brexit victory, barely EUR 110 bn in German sovereign bonds were still eligible.*

[4] *Note, however, that part of the Eurosystem's holdings are comprised of securities that now yield less than -0.4%: available eligible securities are thus more numerous…*

[5] *We do not discuss dropping the maturities limit as it won't be much helpful: Germany has no bonds beyond 30y maturity. Bonds below 2 years have yields below the depo rate. Besides, even though the ECB were to drop the deposit rate floor, buying bonds below 2 years would mean more redemption to roll.*