Annex 1 - Memorandum

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Amendments to the Riksbank's operational framework for the implementation of monetary policy – Step 2

Introduction

The Riksbank's operational framework for the implementation of monetary policy makes it possible for the Riksbank to steer the overnight rate and influence Swedish market rates. The operational framework consists of monetary policy instruments, counterparties and collateral for credit from the Riksbank. By determining the pricing of deposits and loans with the Riksbank, the Riksbank steers the overnight rate and influences the pricing of close substitutes for these investments and loans on the market. The primary objective of the operational framework is to ensure short market rates are close to the Riksbank's policy rate. The transmission mechanism means that changes in short market rates also affect other interest rates in the economy, and ultimately, the economy in general.

The monetary policy operational framework has been changed many times during the Riksbank's 350-year history, both to adapt to new targets and to adapt to new conditions in the world.[1]

Developments in recent years, including changes in the payment market and an expanded group of counterparties mean that the Riksbank's operational framework needs to be reformed again. This is so that it can remain robust and also continue to affect market rates effectively.

Work on reforming the operational framework was started in 2019, but for system-technical reasons is being carried out in two steps. Implementation of the first step started on 9 October 2019, and implementation of the second and final step will start on 8 June 2022.

[1] See Sellin (2018) for an account of how the Riksbank's operational framework changed from 1885 until 2018.

This memorandum opens with a short account of how the monetary policy operational framework was designed before work on reforming it started in 2019, together with a description of the most important driving forces behind the reform. This is followed by a short description of the reform process. Finally, the new operational framework is presented as a whole, including both its design and the underlying reasoning.

Background

The overall nature of the operational framework

The instruments in the Riksbank's operational framework for the implementation of monetary policy consist of standing facilities and market operations. The standing facilities for deposits and loans overnight, interest rates for which are stated as a deviation from the policy rate, set the limits for an 'interest rate corridor' for the overnight rate, in which the deposit rate forms the floor and the lending rate forms the ceiling. The overnight interest rate should lie inside the interest rate corridor because a monetary policy counterparty in need of liquidity can always borrow from the Riksbank against collateral at the lending rate and a monetary policy counterparty with surplus liquidity can always deposit the surplus in the Riksbank at the deposit rate. The sum that can be borrowed in the lending facility is limited by the adjusted value of the collateral provided by the counterparty and there is no limit on how much a counterparty may deposit in the deposit facility. As there is a difference between the deposit and lending rates, counterparties have an incentive with regard to intraday loans to agree on an interest rate that lies between the rates they would pay to or receive from the Riksbank.

The Riksbank's ability to steer the overnight rate within the interest rate corridor is also strengthened through market operations. The Riksbank's monetary policy counterparties are thereby given the opportunity to deposit or borrow, depending on the banking system's total liquidity position towards the Riksbank, risk-free and at an interest rate corresponding to the Riksbank's policy rate. With full allocation in the market operations, the overnight rate is at the same level as the policy rate, while a deviation arises to the extent the Riksbank limits allocation.

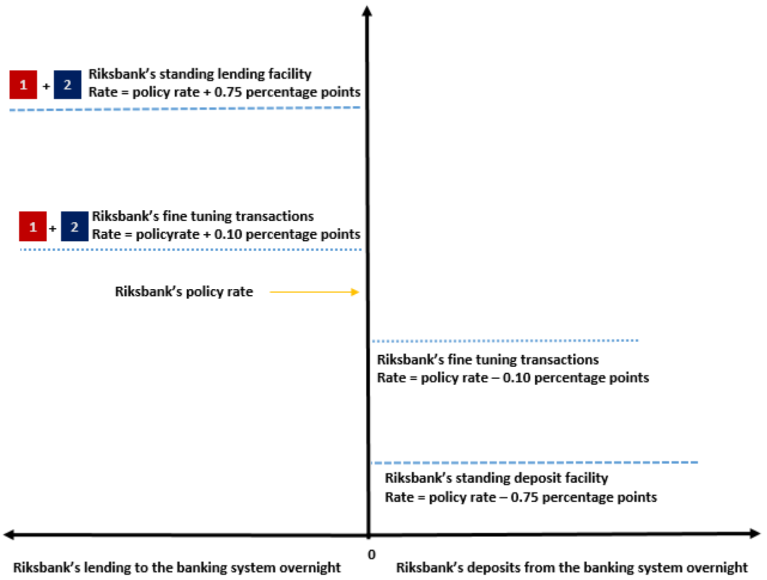
The earlier operational framework

The Riksbank's operational framework for the implementation of monetary policy before reforms were initiated in October 2019 is illustrated in Figure 1 below. Pricing of the standing facilities was such that the deposit rate equalled the Riksbank's policy rate after a deduction of 0.75 percentage points and the lending rate equalled the policy rate with a supplement of 0.75 percentage points. All types of collateral accepted by the Riksbank (primary and secondary collateral volumes) were accepted as collateral for credit in the Riksbank's standing loan facility.

The standing facilities were complemented by daily market operations known as fine-tuning transactions. The transactions were carried out every business day between 16.00 and 16.40 and involved the Riksbank offering overnight deposits at an interest rate corresponding to the policy rate after a deduction of 0.10 of a percentage point in the event of a liquidity surplus, as well as collateralised credit (primary and secondary collateral volumes) at an interest rate corresponding to the policy rate with a supplement of 0.10 of a percentage point in the event of a liquidity deficit. At most, the fine-tuning amount was equal the banking system's total surplus or deficit, and allocation took place according to a 'first come, first served' principle.

In addition to daily market operations, the Riksbank also conducted weekly market operations to supply liquidity to or drain liquidity from the banking system, either by offering monetary policy repos or by issuing Riksbank Certificates with a one-week maturity. As the banking system has had a liquidity surplus towards the Riksbank since 2008, operations took the latter approach for a long time.

Figure 1. The Riksbank's monetary policy operational framework before reforms were initiated in October 2019



Note. The cubes refer to which collateral is accepted in the respective facility, primary or secondary collateral volume. In addition to the standing deposit and lending facilities and daily market operations shown in the figure, the Riksbank offers weekly market operations, see above text.

Reforms in two steps

Developments in the world around us mean that the Riksbank's operational framework for the implementation of monetary policy needs to be reformed to make it simpler and more automated and to keep it robust and flexible in the future.

The most important drivers of change in the surrounding world are:

- an increased interest in becoming a monetary policy counterparty to the Riksbank;
- factors that affect the Riksbank's management of liquidity – such as the special deposit facility for central counterparties (CCPs); and
- developments in the payment market with a greater volume of instant payments that require the Riksbank's payment system, RIX, to have longer opening hours and, in the near future, the Riksbank to offer a settlement service for instant payments in Riksbank money and, in the longer term, possibly to offer some form of central bank digital currency, such as an e-krona.

The monetary policy operational framework needs to be adapted in order to tackle these changes and similar phenomena which may arise in the future so as to be able to continue to steer the overnight rate and effectively influence other market rates.

Consequently, in July 2019, the Riksbank therefore circulated a proposed new operational framework for the Riksbank for consultation among the Riksbank's monetary policy counterparties and other interested parties ("The Riksbank's new operational framework for monetary policy", reference number 2019-00786). The proposal included amendments to the Riksbank's operational framework for the implementation of monetary policy in two steps and is based on the objectives and restrictions shown in Table 1 below. The operational framework's primary objective is to stabilise short market rates close to the Riksbank's policy rate.

Tabell 1. Objectives and restrictions for the monetary policy operational framework

Primary objective	Ensure that short-term rates stay close to the Riksbank's policy rate.
Restrictions	The banking system's liquidity position with regard to the Riksbank shall not affect target attainment.
	All stakeholders must be able to understand how the monetary policy operational framework functions - it must therefore be simple, clear and predictable.
	Monetary policy counterparties shall be treated equally.
	Efficient payment system.
Secondary objectives	Cost-efficient implementation.
	Low operational risks.
	Limited financial risks.

On 24 September 2019, having taken consideration of received consultation responses, the Executive Board decided to implement the changes to the monetary policy operational framework in the first step from 9 October 2019. In connection with this, the Executive Board also took a decision of principle on implementing the changes in step two as soon as possible in terms of system technology – but no later than within two years.

The Executive Board also decided to instruct the Head of the Markets Department to report back to the Executive Board with amendments to the Riksbank's framework for the implementation of monetary policy in accordance with the remaining proposals in stage two of the referred memorandum.

As of the spring of 2022, it has been technically possible to implement the second step of changes to the operational framework and, on 22 March 2022, the Executive Board decided to implement this as of 8 June 2022.

The **first step** entails that the Riksbank, from 9 October 2019:

i. ceased to conduct daily fine-tuning transactions;
ii. determined rates for the Riksbank's standing deposit facility at the prevailing policy rate after a deduction of 0.10 percentage points.

The **second step** entails that the Riksbank, from 8 June 2022 will:

i. change the name of the Riksbank's repo rate to the Riksbank's policy rate;
ii. tighten requirements for collateral for the Riksbank's standing loan facility at the primary collateral volume and retaining current requirements for collateral for intraday credit;
iii. determine rates for the Riksbank's standing lending facility at the prevailing policy rate with a supplement of 0.10 percentage points; and
iv. establish a supplementary liquidity facility, in which the Riksbank will offer credit overnight against collateral from the secondary collateral volume at an interest rate corresponding to the policy rate with a supplement of 0.75 percentage points.

The interest rate for the Riksbank's standing loan facility was set at the prevailing policy rate with the addition of 0.10 percentage points on 2 July 2020 as a part of the measures the Riksbank took to promote the supply of liquidity in the economy and thereby alleviate the economic consequences of the coronavirus pandemic.[2] The purpose of once again determining the interest rate on the standing loan facility as of 8 June 2022 is to clarify that this is a component of the Riksbank's reformed operational framework for the implementation of monetary policy that applies until further notice, regardless of the development of the coronavirus pandemic.

Reformed operational framework

In the reformed monetary policy operational framework, the standing loan facility, together with the standing deposit facility, forms a narrow interest rate corridor, which is the main instrument for the Riksbank to steer the overnight rate and affect short market rates. Alongside the standing loan facility, a supplementary liquidity facility is also being set up to ensure that monetary policy counterparties have access to liquidity overnight, even if they lack the collateral needed to utilise the standing loan facility. The possibilities of steering the overnight rate will also continue to be strengthened with weekly market operations. The operational framework is illustrated in Figure 2 below.

[2] In a first step, the interest rate on the standing loan facility was cut from the prevailing policy rate with a supplement of 0.75 percentage points to the prevailing policy rate with a supplement of 0.20 percentage points on 18 March 2020, also in response to the pandemic.

Figure 2. The Riksbank's new monetary policy operational framework

Note. The cubes refer to which collateral is accepted in the respective facility, primary or secondary collateral volume. In addition to the standing deposit and lending facilities shown in the figure, the Riksbank offers weekly market operations, see the section market operations.

Standing facilities

The standing deposit and loan facilities

Design

In the reformed monetary policy operational framework, the overnight rate[3] is mainly steered using interest rate setting on the standing deposit and loan facilities:

- The interest rate for the Riksbank's standing deposit facility amounts to the prevailing policy rate after a deduction of 0.10 percentage points.
- The interest rate for the Riksbank's standing lending facility amounts to the prevailing policy rate with a supplement of 0.10 percentage points.

This means that a narrow interest rate corridor of 0.20 percentage points is being established, compared with the earlier operational framework in which the difference between the deposit and loan rate amounted to 1.5 percentage points (deduction/supplement of 0.75 percentage points), combined with fine-tuning transactions at interest rates corresponding to the policy rate after a deduction/supplement of 0.10 percentage points.

In the reformed operational framework, the collateral requirements for the standing loan facility are being tightened. This tightening is based on the division of eligible

[3] The term overnight rate refers not only to interest on liquidity balancing between the monetary policy counterparties, but also to the interest on loans between monetary policy counterparties and their customers/counterparties.

collateral into a primary and a secondary collateral volume (named A and B collateral in the consultation) as shown below.

Assuming that the other applicable conditions[4] have been met, the primary collateral volume is made up of:

i. securities issued by governments
ii. securities issued by central banks
iii. other receivables at central banks.

The secondary collateral volume is comprised of other assets accepted by the Riksbank as collateral. Assuming that the other applicable conditions[5] have been met, they are made up of:

i. securities issued by international organisations
ii. securities guaranteed by governments
iii. covered securities, taking restriction rules into account
iv. securities issued by agencies
v. other eligible securities

In the standing loan facility, credit is only accepted against the primary collateral volume, compared with the previous operational framework, under which both primary and secondary collateral volumes were accepted.

Reasoning

The earlier operational framework, with its manual fine-tuning transactions, had the disadvantage of requiring considerable resources and being linked to operational risks. These risks also increased in step with the number of monetary policy counterparties. The system was also complicated by the banking system's liquidity position being affected by a number of autonomous factors that are difficult to forecast. The fine-tuning transactions were also incompatible with longer opening hours in RIX and payment settlements around the clock. Removing these makes the operational framework simpler, more predictable and more automated.

Setting the interest rate for the standing deposit and loan facilities at the policy rate with a deduction/supplement of 0.10 percentage points, will retain the marginal cost for loans and deposits with the Riksbank from the previous operational framework. At the same time, a narrower corridor will make the overnight rate less sensitive to how the liquidity in the banking system is divided between the banks at the end of the day. This reduces the volatility of the overnight rate on the market. In the event of an imbalance in which one bank is depositing liquidity with the Riksbank while another is borrowing, both should face interest rates that are close to the Riksbank's policy rate. However, a difference of 0.20 percentage points between the deposit and loan rate should continue to provide incentive for some activity on the interbank market. This is particularly true considering that loans from the Riksbank are offered against collateral in the form of government securities and claims on central banks, while the banks, as a rule, borrow from each other without providing collateral.

[4] Terms and conditions for RIX and monetary policy instruments.
[5] Ditto.

Tightened collateral requirements reinforce the counterparties' incentive to seek market solutions to manage their liquidity positions. They also create incentives for the counterparties to primarily use government securities and claims on central banks as collateral for credit from the Riksbank, and secondly use more risky assets, such as covered bonds.

The supplementary liquidity facility

Design

Alongside the standing loan facility, a new supplementary liquidity facility is being set up. Using the supplementary liquidity facility, monetary policy counterparties will be able to receive credit overnight from the Riksbank against collateral from the secondary collateral volume at an interest rate corresponding to the policy rate with a supplement of 0.75 percentage points.

If a monetary policy counterparty has a negative balance on its RIX account when the payment system closes, this will be interpreted as a request from the counterparty to utilise the standing loan facility. If the negative balance exceeds the value of primary collateral pledged by the counterparty, this will be interpreted as a request from the counterparty to utilise the supplementary liquidity facility at the higher interest rate.

Reasoning

Given that collateral from both the primary and the secondary collateral mass is accepted for intraday credit, it is important to ensure that a situation does not arise in which counterparties can borrow during the day but not overnight. The possibility to borrow overnight from the Riksbank against collateral in the secondary collateral mass shall thus remain to ensure that monetary policy counterparties have access to liquidity overnight even if they do not have sufficient collateral in the primary collateral mass to use the standing loan facility. In this sense, the supplementary liquidity facility can be seen as a form of last resort solution for monetary policy counterparties to avoid unnecessary disruptions in the payment system and the rate-setting of short-term market rates.

Rate-setting in the supplementary liquidity facility reflects the interest spread between securities in the primary and the secondary collateral masses with an addition, partly to create an incentive for the counterparties to first and foremost use collateral from the primary collateral mass when borrowing from the Riksbank, and partly to strengthen the incentive for the counterparties to seek market solutions to manage their liquidity.

Market operations

Weekly operations

Design

Like the earlier operational framework, the new operational framework includes weekly market operations to add or drain liquidity to or from the banking system at an interest rate corresponding to the Riksbank's policy rate. When draining liquidity, the operations can be carried out either through issues of Riksbank Certificates with a one week maturity, as now, or through deposits with a one week duration. In the event the

Riksbank needs to add liquidity, the operations can be carried out either through monetary policy repos or through lending against the primary collateral volume with a one week duration.

Reasoning

This type of operation is needed when the banking system's liquidity position with regard to the Riksbank shows a large surplus or deficit, and this affects the overnight rate's position within the interest rate corridor. The purpose of the operations is stabilise the overnight rate close to the policy rate.

Name change for the repo rate

Design/Reasoning

In conjunction with the Riksbank's reformation of its monetary policy operational framework, it is appropriate to change the name of the interest rate on which the Executive Board of the Riksbank takes decisions, the Riksbank's repo rate. The Riksbank uses the repo rate to signal which interest rate level is needed to attain the inflation target. The current name, the Riksbank's repo rate, refers to monetary policy repos, which are a monetary policy instrument that has not been used by the Riksbank since the year 2008. This is because the banking system has since then had a liquidity surplus towards the Riksbank and thus not had a regular borrowing requirement from the Riksbank. The change of name shall of course be seen in this light and it is emphasised that the change does not entail any real change. The change merely ensures that the rate has a more appropriate name. The name change should therefore not affect existing and outstanding contracts referring to the Riksbank's repo rate, given that the contracts refer to the function of the interest rate and not the name in itself.

Concluding remarks

The changes to the operational framework implemented on 8 June 2022 should be seen in the context of the changes of the operational framework implemented in the first step of the reform on 9 October 2019. The overall changes of the operational framework are primarily motivated by the needs both to simplify and automate the operational framework and to make the operational framework flexible and independent of autonomous factors that could disrupt the Riksbank's possibilities of stabilising the overnight rate close to the policy rate. The changes to the operational framework in step two will complete the reform initiated in 2019.

The amendments to the Riksbank's operational framework for the implementation of monetary policy are of a technical nature and are not intended to change the direction of monetary policy.

References

Sellin, Peter (2018), "The Riksbank's operational framework for implementing monetary policy 1885-2018", Economic Review 2018:2, pp. 48-79, Sveriges Riksbank.