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# Risk endogeneity at the lender/investor-of-last-resort<sup>☆</sup>

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## ABSTRACT

To what extent can a central bank influence its own balance sheet credit risks during a financial crisis through unconventional monetary policy operations? To study this question we develop a risk measurement framework to infer the time-variation in portfolio credit risks at a high (weekly) frequency. Focusing on the Eurosystem's experience during the euro area sovereign debt crisis between 2010 and 2012, we find that the announcement and implementation of unconventional monetary policy operations generated beneficial risk spill-overs across policy portfolios. This caused overall risk to be nonlinear in exposures. In some instances the Eurosystem reduced its overall balance sheet credit risk by doing *more*, in line with Bagehot's well-known assertion that occasionally "only the brave plan is the safe plan."

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## 1. Introduction

For at least 150 years, going back to (Bagehot, 1873; Thornton, 1802), central bankers have wondered to what extent they can actively influence rather than only passively accept their own balance sheet risks during a financial crisis. Theoretically, the possibility of the central bank influencing its own risk is uncontroversial. In the context of a pure illiquidity crisis without solvency concerns, for example, the simple announcement by a central bank to act as a generalized lender-of-last-resort (LOLR) to the entire financial system in line with Bagehot-inspired principles<sup>1</sup> could shift the economy from a 'bad' to a 'good' equilibrium, causing all illiquidity-related credit risks to quickly disappear at virtually no cost or additional central bank balance sheet risk; see e.g. Diamond and Dybvig (1983), Rochet and Vives (2004), Reis (2013), and Bindseil (2014). Additionally, the central bank's announcement to act as an investor-of-last-resort (IOLR) by purchasing stressed assets in

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<sup>1</sup> Bagehot (1873) famously argued that the lender-of-last-resort should lend freely to solvent banks, against good collateral valued at pre-crisis levels, and at a penalty rate; see also Rochet and Vives (2004) and Freixas et al. (2004).

malfunctioning markets could similarly shift expectations, possibly leaving the central bank's credit risk unaffected; see Calvo (1988), ECB (2014), Corsetti and Dedola (2016), and Acharya et al. (2018). Whether such possibilities are based on wishful "Münchhausen thinking,"<sup>2</sup> or are instead empirically relevant, is currently unclear. Empirical studies of central banks' financial risks are rare, primarily because the required data are almost always confidential. As a result, to our knowledge, the response of central bank credit risks to large-scale unconventional monetary policies has remained unexplored.

It is uncontroversial that lending freely in line with (Bagehot, 1873)-inspired principles as well as purchasing assets on stressed markets during a financial crisis can increase the overall credit risk of a central bank's balance sheet. How different LOLR and IOLR policies interact from a risk perspective, however, is currently unclear. Specifically, we ask: Can *increased* central bank liquidity provision or asset purchases during a financial crisis *reduce* bottom line central bank risks? This could happen if risk-taking in one part of the balance sheet (e.g., more asset purchases) de-risks other balance sheet positions (e.g., the collateralized lending portfolio) by a commensurate or even larger amount. Focusing on the euro area during the sovereign debt crisis between 2010 and 2012, how economically important were such risk spillovers across monetary policy operations? Were the relevant financial buffers at all times sufficiently high? Finally, did unconventional operations differ in terms of beneficial economic impact per additional unit of risk?

We argue that the Eurosystem's experience during the euro area sovereign debt crisis is an ideal laboratory to study the impact of a central bank's LOLR and IOLR policies on the credit risk it assumes. Between 2010 and 2012, severe liquidity squeezes and market malfunctions forced the Eurosystem – the European Central Bank (ECB) and its then 17 national central banks (NCBs) – to act as a LOLR to the entire financial system; see e.g. ECB (2014), Drechsler et al. (2016), and de Andoain et al. (2016). Large-scale central bank lending to all banks helped avert a collapse of vital parts of the financial system and, with it, supported the transmission of monetary policy. Large-scale liquidity provision occurred via main refinancing operations (MROs), multiple long-term refinancing operations (LTROs), as well as two very-long-term refinancing operations (VLTROs), all backed by repeated expansions of the set of eligible collateral. In addition, the Eurosystem acted as an IOLR in stressed markets. For example, it purchased government bonds in malfunctioning secondary markets within its Securities Markets Programme (SMP) between 2010 and 2012, and committed to doing so again under certain circumstances within its Outright Monetary Transactions (OMT) program as announced in August 2012.

The Eurosystem's actions as a large-scale LOLR and IOLR to support stressed banks and sovereigns had a first-order impact on the size, composition, and, ultimately, the credit risk of its balance sheet. At the time, its policies raised substantial concerns about the central bank taking excessive risks (and supporting moral hazard) by helping troubled counterparties. Particular concerns related to the potential effect of a materialization of credit risk on the ECB's reputation, independence, and ultimately its ability to steer inflation towards its target of close to but below 2% over the medium term. The credit risk concerns were so pronounced at the time that some media outlets started referring to the ECB as the ECBB: Europe's Central Bad Bank; see e.g. Brendel and Pauly (2011) and Böhme (2014).

By focusing on credit risk we do not intend to imply that other risk components – interest rate risk, exchange rate risk, liquidity risk, political risk, redenomination risk, and various other market risks – are not important. The credit risk component of central banks' balance sheets, however, has received particular and increasing attention from the public and the financial press since the global financial crisis; see e.g. Buiter and Rahbari (2012), Böhme (2014), and Bindseil and Laeven (2017). This attention has not waned given the complex and large balance sheets of currently all major central banks; see e.g. Greenlaw et al. (2013) and Reis (2018). Even in normal times, few central banks globally can afford to implement monetary policy simply by buying or selling (or lending against) entirely credit-risk-free financial assets.<sup>3</sup>

The methodological part of this paper introduces a reduced-form credit risk measurement framework that allows us to study the above questions. The framework is based on a tractable model for dependent defaults that can accommodate a large number of bank and sovereign counterparties simultaneously. The model allows us to capture extreme joint tail dependence, time-varying volatility and correlation parameters, as well as a potential asymmetry in the correlation dynamics. These empirical features are not unique to central bank portfolios but instead can apply to any large diversified asset or collateralized lending portfolio. We thus expect our risk framework to be of interest also for non-central-bank financial institutions that seek to repeatedly infer their portfolio credit risks at a high (weekly) frequency.

We stress that a central bank's risk management function is different from that of a commercial bank in at least three ways. First, risk and profitability are not first-order measures of success for a central bank. When taking monetary policy decisions the financial consequences for the central bank's bottom line are usually not a primary concern. If a central bank endures sustained losses, however, its independence may be, or perceived to be, impinged, which in turn may have adverse consequences for its ability to achieve its goals and economic welfare.

Second, commercial banks, by engaging in maturity transformation, are by their very nature exposed to liquidity shocks. By contrast, central banks are uniquely able to provide liquidity-support in a financial crisis owing to the fact that they are never liquidity-constrained in the currency they issue; see e.g. Bindseil (2014) and Reis (2015). Consequently, the default risk of the central bank itself on its domestic currency liabilities is negligible even during an existential financial crisis.

<sup>2</sup> This fictional German nobleman remarkably pulled himself, along with his horse, out of a morass by his own hair.

<sup>3</sup> Risk concerns have remained a constant thorn in the side of monetary policy implementation. Historically, central banks have aimed to protect their balance sheets from unnecessary financial risks and avoid undue market non-neutrality through carefully designed collateral frameworks; see e.g. Cheun et al. (2009) for a survey.

Finally, a small or medium-sized commercial bank is unlikely to be able to materially influence financial risks and risk correlations. Commercial banks are ‘risk takers’ in more than one sense – risk management is primarily about choosing exposures at *given* risks. This is inherently less true for central banks, as we show. Instead, point-in-time risk measures and risk correlations respond to a central bank’s communication and large-scale actions, and are *endogenous* in this sense, particularly during a financial crisis. Philosophically, this requires a particular mindset of a central bank’s risk management function, thinking as economists at least as much as agree quants.

The empirical part of this paper applies our credit risk framework to the Eurosystem’s consolidated conventional and unconventional monetary policy portfolios. We thus contribute to a growing literature that applies stress-testing methods to central banks’ assets and income.<sup>4</sup> Exposures are taken from the Eurosystem’s balance sheet and measured at a weekly frequency between 2009 and 2015. Standard point-in-time risk measures are obtained from Moody’s Analytics (for banks) or are calculated from CDS spreads (for sovereigns), also at a weekly frequency. All risk model parameters are estimated by the method of maximum likelihood. Common portfolio risk measures, such as the expected loss and expected shortfall, are obtained through Monte Carlo simulation. We compare model-implied portfolio credit risks shortly before and after key policy dates. This ‘high-frequency’ weekly assessment identifies the effect of each policy on its own and other portfolio credit risks; see e.g. Rogers et al. (2014) and Fratzscher and Rieth (2018) for similar event-study approaches.

We focus on three empirical findings. First, we find that LOLR- and IOLR-implied credit risks tend to be negatively related in our sample. Taking additional risk in one part of the central bank’s balance sheet (e.g., the announcement and implementation of SMP asset purchases) tended to de-risk other positions (e.g., the collateralized lending exposures from previous LTROs). Vice versa, the allotment of two large-scale VLTRO credit operations each decreased the expected shortfall of the SMP asset portfolio. As a result of these risk spillovers, central banks’ overall risks can be nonlinear in exposures. In bad times, additional lending or asset exposures can increase overall risk less than proportionally. Conversely, reducing balance sheet size after the crisis may not reduce total risk by as much as one would expect by linear scaling.

Second, some unconventional policy operations reduced rather than added risk to the Eurosystem’s balance sheet in bottom line terms. For example, we find that the initial OMT announcement de-risked the Eurosystem’s balance sheet by € 41.4 bn in 99% expected shortfall (ES). The announcement of OMT technical details in September 2012 was associated with a further reduction in 99% ES of € 18.1 bn. As another example, the allotment of the first VLTRO in late 2011 raised the 99% ES associated with VLTRO lending from zero to approximately € 27.6 bn. However, the allotment also sharply reduced the need for shorter-term central bank funding, and in addition de-risked the SMP asset portfolio as banks funneled some of the additional central bank liquidity into government bonds, mitigating sovereigns’ funding stress; see e.g. Drechsler et al. (2016). The overall 99% ES increased, but only marginally so, by € 0.8 bn. The total expected loss decreased, by € 1.4 bn. We conclude that, in exceptional circumstances, a central bank can remove excess risk from its balance sheet by doing *more*, in line with Bagehot (1873)’s well-known assertion that occasionally “only the brave plan is the safe plan.”

A reduction in net risk is by no means guaranteed, however. A central bank’s risk response can go either way. Which way it goes likely depends on market perceptions about the sustainability of and the central bank’s commitment to its unconventional policies, and therefore its communication with the public. For example, the asset purchases that were implemented in the week following the SMP’s initial announcement in May 2010 raised the 99% ES of the SMP portfolio from zero to approximately € 7.3 bn. The policy announcement and the initial purchases spilled over and helped de-risk the collateralized lending book to some extent. The total 99% ES, however, still increased, by € 5.1 bn. As a second example, the extension of the SMP to include Spain and Italy in August 2011 did not reduce total balance sheet risk. This time the effect did not even spill over to reduce the risks of the other monetary policy portfolios. This exception is likely related to the pronounced controversy regarding the extension of the SMP at that time. The full extent of the controversy became evident with the resignation of the Bundesbank President in February 2011 and an ECB Executive Board member in September 2011. The divided decision, as well as commun/ecedented policy, may have caused market participants to doubt that the SMP would be active for long and substantial in size, lessening its economic and risk impact.

Third, our risk estimates allow us to study past unconventional monetary policies in terms of their ex-post ‘risk efficiency.’ Risk efficiency is the notion that policy impact should be maximal given a certain increase in balance sheet risk. Given an estimate of policy impact (e.g., a change in long-term inflation swap rates around the time of a policy announcement) and an appropriate estimate of risk (e.g., the change in 99% ES), it is possible to evaluate different policies ex-post by scaling the former by the latter. Doing so, we find that the ECB’s OMT program was particularly ex-post risk efficient. Its announcement *increased* long-term inflation expectations away from deflationary tendencies towards the ECB’s target of close to but below two percent, *decreased* sovereign benchmark bond yields of stressed euro area countries, while *removing* risk from the central bank’s balance sheet (a win-win-win). Further, we find that the first allotment of VLTRO funds was more risk-efficient than its second installment. The SMP, despite its benefits documented elsewhere (e.g. Eser and Schwaab, 2016, Ghysels et al., 2017), does not appear to have been a particularly risk-efficient policy measure as defined above.

<sup>4</sup> For example, (Carpenter et al., 2013; Greenlaw et al., 2013) stress-test the Federal Reserve’s ability to send positive remittances to the U.S. Treasury given that a large-scale government bond portfolio exposes the Fed (and thus indirectly the Treasury) to interest rate risk. Christensen et al. (2015) advocate the use of probability-based stress tests, and find that the risk of temporarily suspended Fed remittances to the Treasury is small but non-negligible (at approximately 10%). Finally, Del Negro and Sims (2015) consider conditions under which a central bank might need to withhold seigniorage, or request recapitalization from the treasury, in order to maintain its monetary policy commitments.

Our findings can have important implications for the design of central banks' post-crisis operational frameworks; see e.g. Reis (2018, 2019). As a first key takeaway, a certain amount of excess central bank liquidity for monetary policy purposes can be provided via both credit operations and asset purchases. We find that collateralized credit operations imply substantially less credit risks (by at least one order of magnitude in our sample) than outright government bond holdings per € 1 of liquidity owing to the double recourse built into collateralized lending as well as the diversification over a much larger set of counterparties. Such pronounced differences in portfolio risk may be relevant for the decision whether to provide additional central bank liquidity via collateralized lending operations or via outright asset purchases. Second, expanding the set of eligible assets during a liquidity crisis could help mitigate the procyclicality inherent in some central bank's risk protection frameworks. Our results suggest that doing so does not necessarily increase a central bank's overall level of credit risk. Third, central bank communication on unprecedented monetary policy measures should, ideally, be unanimous and detailed to be effective and risk-efficient (see SMP versus OMT). Finally, risk spillovers across monetary policy portfolios may call for gradualism in reducing balance sheet size after a financial crisis.

The remainder of the paper is set up as follows. Section 2 presents our exposure data. Section 3 introduces our high-dimensional credit risk measurement framework. Section 4 applies the framework to a subset of the Eurosystem's balance sheet. Section 5 concludes. A Web Appendix presents additional results and technical details.

## 2. Eurosystem operations

We study the time variation in Eurosystem portfolio credit risks, with a particular focus on such risks just before and after key monetary policy announcements during the euro area sovereign debt crisis. We focus on six announcements that are related to three unconventional monetary policy operations: the SMP, the VLTROs, and the OMT. This section first discusses these operations, and then presents the relevant point-in-time exposure data.

The Eurosystem adjusts the money supply in the euro area mainly via so-called refinancing operations that usually take the form of repos. Eurosystem refinancing operations between 2009 and 2015 included main refinancing operations (MROs), various long-term refinancing operations (LTRO < 1y, LTRO-1y), very-long-term refinancing operations (VLTROs), and targeted long-term refinancing operations (TLTROs). Between 2010 and 2012 the Eurosystem also conducted asset purchases within its SMP program. We collectively refer to the LTRO-1y, VLTROs, TLTROs, SMP, and OMT as unconventional monetary policy operations. The financial risks and profits associated with these policy portfolios have been shared across the Eurosystem since their inception. We refer to Web Appendix A for details on the SMP, the VLTROs, and the OMT.

Our study includes all exposures from refinancing operations and almost all asset portfolios held outright for monetary policy purposes within our sample. We exclude assets purchased within the Expanded Asset Purchase Programme (APP) commencing in March 2015 since the APP was unrelated to generalized lender-/investor-of-last-resort motivations. In addition, the risks and profits associated with the APP are subject to different risk sharing arrangements across the constituent Eurosystem national central banks.<sup>5</sup> We further exclude the first two covered bond purchase programmes (CBPP1 and CBPP2) because of their small sizes (€ 60 bn and € 16.4 bn at their respective peaks) and low default rates. Finally, we exclude non-monetary policy related portfolios such as the ECB's Own Funds Portfolio.

Fig. 1 plots selected items of the Eurosystem's weekly balance sheet between 2009 and 2015.<sup>6</sup> We distinguish five different liquidity operations: MRO, LTRO < 1y, LTRO1y, VLTRO3y, and TLTRO. The figure also plots the par value of assets held in the SMP portfolio. Clearly, the Eurosystem's balance sheet varied in size, composition, and thus credit risk during the course of the global financial crisis and euro area sovereign debt crisis. A peak in total assets was reached in mid-2012, at approximately € 1.5 trn, following two VLTROs and SMP asset purchases.

Fig. 2 plots the Eurosystem's country-level collateralized lending exposures, aggregated over the five liquidity-providing operations of Fig. 1. The largest share of collateralized lending was tapped by banks in Italy and Spain, and also Greece, Ireland, and Portugal. These sovereigns (and their banks) were perceived by markets to be particularly affected by the euro area sovereign debt crisis; see Section 3.2 below. Banks from non-stressed countries such as Germany and France were less liquidity-constrained and therefore relied less heavily on Eurosystem funding during the crisis.

## 3. Risk measurement framework

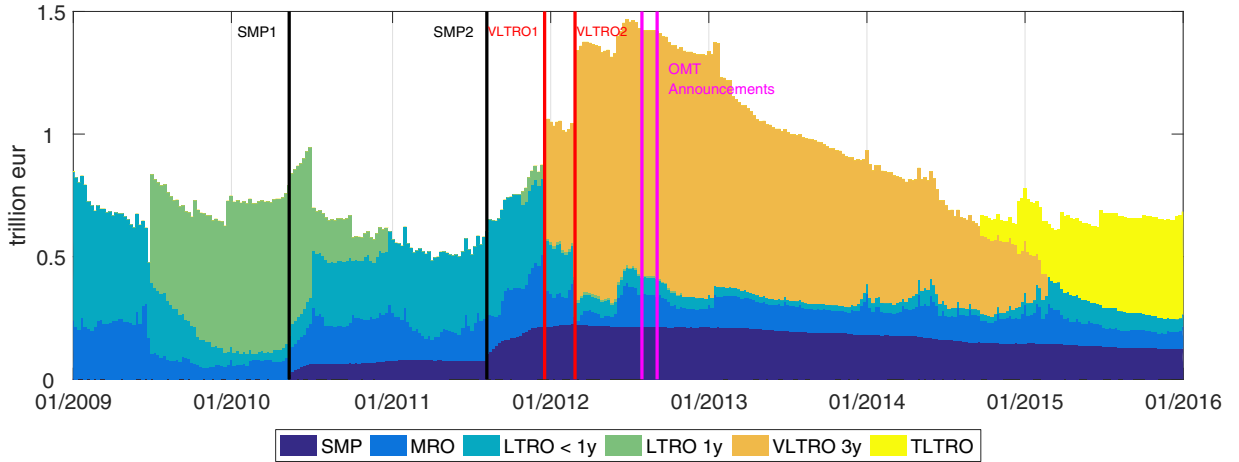
### 3.1. Portfolio risk measures

Credit losses at time  $t = 1, \dots, T$  over a one-year-ahead horizon are only known with certainty after the year has passed, and are uncertain (random) at time  $t$ . The probability distribution of ex-ante credit losses is therefore a key concern for risk measurement. We model total credit losses  $\ell_t(k)$  associated with potentially many counterparties  $i = 1, \dots, N_t(k)$  as

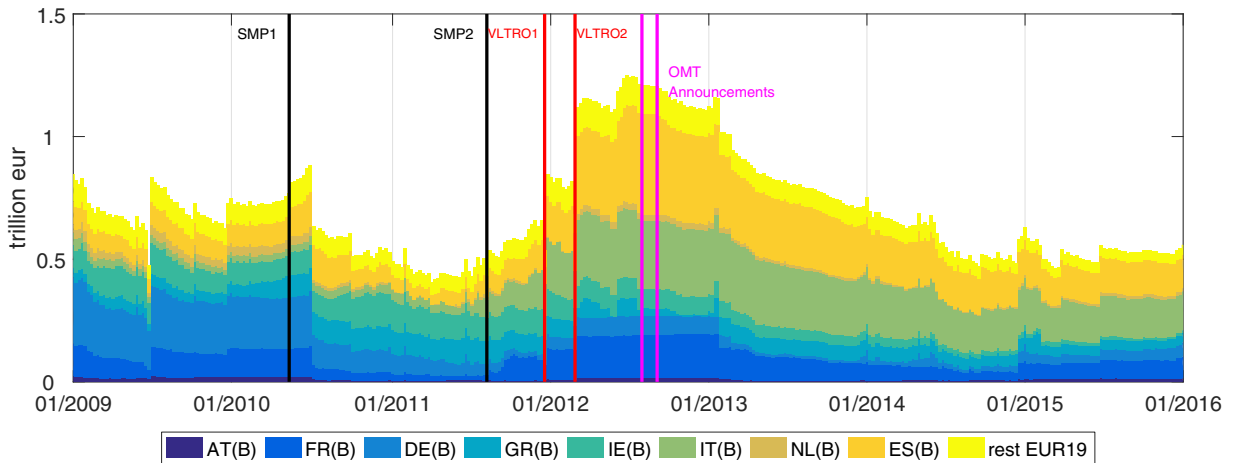
$$\ell_t(k) = \sum_{i=1}^{N_t(k)} \ell_{it}(k) = \sum_{i=1}^{N_t(k)} 1(\text{default}_{i,t+1:t+52}) \cdot \text{LGD}_{i,t+1:t+52} \cdot \text{EAD}_{i,t+1:t+52}(k), \quad (1)$$

<sup>5</sup> We refer to ECB (2014, 2015). A discussion of the European institutional framework and euro area risk sharing arrangements across NCBs is beyond the scope of this paper.

<sup>6</sup> The Eurosystem's balance sheet is public; see <http://sdw.ecb.europa.eu/browse.do?node=9691110>.



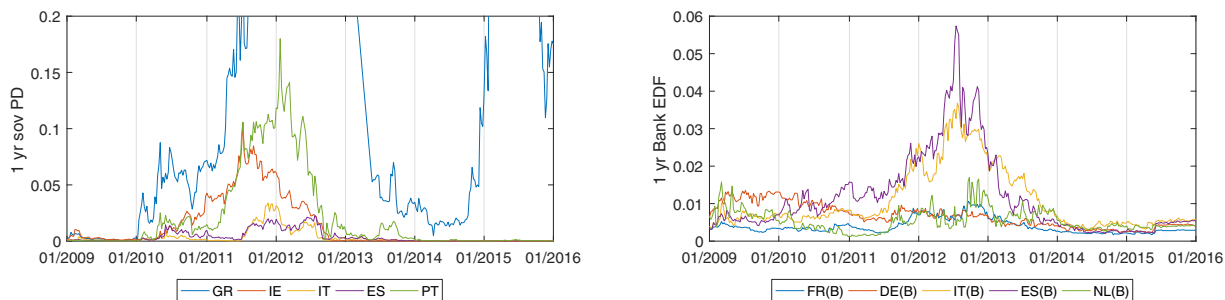
**Fig. 1.** Eurosystem collateralized lending and SMP exposures Total collateralized lending exposures associated with different liquidity operations (MRO, LTRO < 1y, LTRO1y, VLTRO3y, TLTRO), as well as government bond holdings within the Securities Markets Programme (SMP). Vertical axis is in trillion euro. Data is weekly between 2009 and 2015. Two black vertical lines refer to the initial announcement of the SMP on 10 May 2010 (SMP1) and the cross-sectional extension of the program to include Italy and Spain on 08 August 2011 (SMP2). Two red vertical lines mark the allotment of the first and second three-year VLTRO on 20 December 2011 and 28 February 2012, respectively. Two purple vertical lines mark the initial announcement of the OMT on 02 August 2012 (OMT1) and the announcement of its technical details on 06 September 2012 (OMT2). (For interpretation of the references to colour in this figure legend, the reader is referred to the web version of this article.)



**Fig. 2.** Eurosystem collateralized lending across countries Exposures across different euro area countries from five liquidity-providing operations; see Fig. 1. The vertical axis is in trillion euro. Vertical black, red, and purple lines indicate six monetary policy announcements as described in Fig. 1. Data is weekly between 2009 and 2015. (For interpretation of the references to colour in this figure legend, the reader is referred to the web version of this article.)

where  $k = 1, \dots, 6$  denotes monetary policy operations (e.g., LTRO lending or SMP asset holdings),  $N_t(k)$  is the total number of both bank and sovereign counterparties that are relevant for operation  $k$ ,  $\ell_{it}(k)$  is the counterparty-specific one-year-ahead loss between week  $t + 1$  and  $t + 52$ ,  $1(\text{default}_{i,t+1:t+52})$  is an indicator function that takes the value of one if and only if counterparty  $i$  defaults between  $t + 1$  and  $t + 52$ ,  $\text{LGD}_{i,t+1:t+52} \in [0, 1]$  is the loss-given-default as a fraction of  $\text{EAD}_{i,t+1:t+52}(k)$ , and  $\text{EAD}_{i,t+1:t+52}(k)$  is the exposure-at-default associated with counterparty  $i$  and policy operation  $k$ . A default happens when the log-asset value of counterparty  $i$  falls below its counterparty-specific default threshold; see e.g. Merton (1974) and CreditMetrics (2007). The loss  $\ell_{it}(k)$  is random because it is a function of three random terms: the default indicator, LGD, and EAD. Total losses from monetary policy operations are given by  $\ell_t = \sum_{k=1}^K \ell_t(k)$ . We focus on a one-year-ahead risk horizon to align our estimates with the common annual reporting frequency.

We adopt a static balance sheet assumption in our empirical study. This implies that risk parameters at time  $t$  are held constant between  $t + 1$  and  $t + 52$ . In addition, exposures with maturities below the risk horizon are reinvested (for assets) or appropriately rolled over (for loans); see Section 3.4. As a result, the maturity structures of the policy portfolios are less relevant, and using a one-year risk horizon is without loss of much generality. Risk measures for different year-ahead horizons, when available, tend to be highly correlated.



**Fig. 3.** Sovereign and banking sector EDFs Left panel: One-year-ahead CDS-implied-EDFs for five SMP sovereigns. Right panel: One-year-ahead banking sector EDF indices at the country level for the five largest euro area countries: Germany, France, Italy, Spain, and the Netherlands. Data is weekly between 2009 and 2015.

Portfolio risk measures are typically based on moments of the ex-ante loss distribution. We focus on standard risk measures such as the expected loss and expected shortfall at a confidence level  $\gamma$ ,

$$EL(k)_t = \mathbb{E}_t[\ell_t(k)],$$

$$ES(k)_t^\gamma = \mathbb{E}_t[\ell_t(k) \mid \ell_t(k) \geq \text{VaR}^\gamma(\ell_t(k))],$$

where  $\Pr[\ell_t(k) \geq \text{VaR}^\gamma(\ell_t(k))] \equiv 1 - \gamma$  implicitly defines the value-at-risk at confidence level  $\gamma$ , and  $\mathbb{E}_t[\cdot]$  is the conditional time  $t$  expectation over all sources of randomness in (1). Moments of the loss density can easily be obtained by simulation; see Section 4.2. The expected shortfall  $ES(k)_t^\gamma$  is often interpreted as the “average VaR in the tail,” and is typically more sensitive to the shape of the tail of the loss distribution.

The remainder of this section reviews the modeling of the ingredients of (1) from left to right: marginal default probabilities and dependence, LGD, and EAD.

### 3.2. Bank and sovereign EDFs

We rely on expected default frequency (EDF) data from Moody’s Analytics, formerly Moody’s KMV, when assigning point-in-time probabilities of default,  $p_{it}$ , to Eurosystem bank counterparties. One-year ahead EDFs are connected to (1) as

$$\mathbb{E}_t[1(\text{default}_{i,t+1:t+52})] = \text{EDF}_{it} = p_{it}, \tag{2}$$

where  $\mathbb{E}_t[\cdot]$  denotes the expectations operator conditional on all information available at time  $t$ . EDFs are point-in-time forecasts of physical default hazard rates, and are based on a proprietary firm value model that takes firm equity values and balance sheet information as inputs; see Crosbie and Bohn (2003). EDFs are standard credit risk measurements and are routinely used in the financial industry and credit risk literature; see for example Lando (2003) and Duffie et al. (2009).

EDF measures are available for listed banks only. Many Eurosystem bank counterparties, however, are not listed. At the same time, some parsimony is required when considering many bank counterparties. We address both issues by using one-year-ahead median EDFs at the country-level to measure point-in-time banking sector risk.<sup>7</sup> The right panel of Fig. 3 plots our one-year ahead EDF indices for the ‘big-5’ euro area countries: Germany, France, Italy, Spain, and the Netherlands. During the crisis, most Eurosystem liquidity was taken up by banks located in these countries; see Fig. 2. Banking sector EDF measures differ widely across countries, and peak around mid-2012. Our empirical setup uses nine banking sector EDFs that correspond to the countries shown in Fig. 2.

Unfortunately, firm-value based EDF measures are unavailable for sovereign counterparties. We therefore need to infer physical PDs from observed sovereign CDS spreads. Web Appendix B provides the details of our approach. The left panel of Fig. 3 presents one-year ahead sovereign risk measures for the five SMP countries. Most sovereign CDS-implied-EDFs are visibly correlated with their corresponding banking sector’s EDF, and similarly tend to peak around mid-2012.

### 3.3. Multivariate model for dependent defaults

During and after the Great Financial Crisis the Gaussian dependence model (copula) was occasionally referred to as “the formula that killed Wall Street;” see e.g. Salmon (2009). Since then a consensus emerged that key features of appropriate risk models should include joint fat tails of individual risks, non-Gaussian dependence (to account for dependence in tail areas), instability or time variation in parameters, and potential asymmetries in dependence; see e.g. (McNeil et al., 2015, Ch. 7). These concerns are not unique to central bank portfolios but instead apply to any large diversified asset or collateralized lending portfolio. Our model for dependent defaults presented in this section incorporates the above consensus.

<sup>7</sup> EDF indices based on averages weighted by total bank assets are also available. These look similar but overall appear less reliable, and are not used for this reason.

Our risk model adopts the modeling framework developed previously in [Creal et al. \(2011\)](#) and [Lucas et al. \(2014, 2017\)](#). To tailor the model to the problem at hand, however, we modify it slightly to accommodate a large number of heterogeneous bank and sovereign counterparties. In addition, owing to high dimensions, we seek to capture joint tail dependence and a potential asymmetry in the copula in a computationally more straightforward way. Taken together, this yields a modeling framework that can be of use also to non-central-bank financial institutions.<sup>8</sup>

Following the seminal framework of [Merton \(1974\)](#) and [CreditMetrics \(2007\)](#), we assume that a counterparty  $i$  defaults if and only if its log asset value falls short of a certain default threshold. We assume that this happens when  $changes$  from current log asset values to future ones are sufficiently negative. Specifically, we assume that a default occurs with a time-varying default probability  $p_{it}$ , where

$$p_{it} = \Pr[\tilde{y}_{it} < \tau_{it}] = F(\tau_{it}) \Leftrightarrow \tau_{it} = F^{-1}(p_{it}), \quad (3)$$

where  $\tilde{y}_{it}$  is a one-year-ahead change in log asset value,  $\tau_{it}$  is a default threshold expressed as a log return,  $F$  is the CDF of  $\tilde{y}_{it}$ , and  $p_{it}$  is defined in (2). We stress that (3) is essentially a [Merton \(1974\)](#) model turned on its head in two ways. First, unlike [Merton \(1974\)](#),  $p_{it}$  is treated as an observed *input* in our model. In this way, point-in-time  $p_{it}$  and risk correlations can (and do) respond to market participant's expectations of future central bank actions. Second,  $\tau_{it}$  does not have an economic interpretation in terms of debt levels of the firm. Rather,  $\tau_{it}$  is chosen at each point in time and for each counterparty as the  $p_{it}$ -quantile of  $F$  such that the marginal default probability implied by the multivariate (copula) model coincides with the observed market-implied default probability for that counterparty at that time; see the last equality in (3).<sup>9</sup> The reduced form character of (3) ensures that the model can be used for sovereigns as well, for which asset values are a less intuitive notion.

When modeling dependent defaults, we link default indicators using a Student's  $t$  copula function. In particular, we assume that one-year-ahead changes in log-asset values  $\tilde{y}_{it}$  are generated by a high-dimensional multivariate Student's  $t$  density with covariance matrix  $\Omega_t^{(k)}$  and  $\nu$  degrees of freedom. The covariance matrix depends on  $k$  because different counterparties participate in different monetary policy operations. The mean can be set to zero without loss of generality because copula quantiles shift linearly with the mean. We refer to Web Appendix C for all technical details.

The time-varying covariance matrix  $\Omega_t^{(k)}$  is typically of a high dimension. For example, more than 800 banks participated in the Eurosystem's second VLTRO program. The high dimensions – and time-varying size – of  $\Omega_t^{(k)}$  imply that it is difficult to model directly. We address this issue by working with block equi-correlations within and across countries. These block equi-correlations ([Engle and Kelly, 2012](#)) are gathered in a  $D \times D$  matrix  $\Sigma_t$ , with  $D \ll N_t(k)$ , such that  $\Omega_t^{(k)} = \Omega_t^{(k)}(\Sigma_t)$  is a function of the lower dimensional  $\Sigma_t$ . The smaller matrix  $\Sigma_t$  depends on a vector of latent factors  $f_t \in \mathbb{R}^{D(D-1)/2}$  describing the transformed correlations, such that  $\Sigma_t = \Sigma_t(f_t)$ . The dynamics of  $f_t$  are given by the score-driven specification of [Creal et al. \(2013\)](#), such that the correlations adjust in an optimal way to the data at every time  $t$ ; see [Blasques et al. \(2015\)](#). The transition equation for  $f_t$  is

$$f_{t+1} = \bar{f} + A \cdot u_t + B \cdot f_t + C \cdot \text{asym}(y_t, f_t), \quad (4)$$

where  $\bar{f}$  is a function of the unconditional correlations of the data and serves as a target for the level of  $f_t$ ,  $u_t$  is a vector of innovation terms,  $A$  and  $B$  are scalar parameters determining the dynamics of  $f_t$ , and  $\text{asym}(y_t, f_t)$  is a vector of asymmetry terms that allows for skewness in the unconditional dependence function, with corresponding scalar loading  $C$ ; see Web Appendix C for more details on model specification and parameter estimation. The parameters  $A$ ,  $B$ , and  $C$  need to be estimated. Our empirical application below considers nine banking sector risk indices and five SMP countries, thus  $D = 14 \ll N_t(k) \approx 800$  at any  $t$  and  $k$ ; see [Sections 2](#) and [3.2](#). The correlation model is estimated based on weekly changes in log EDFs.

### 3.4. Loss-given-default (LGD) and exposure-at-default (EAD)

Portfolio risk levels depend substantially on the modeling of the loss fraction given default. We distinguish two separate cases: bank and sovereign counterparties.

Collateralized lending to banks within the Eurosystem's liquidity facilities implies a double recourse. If a bank defaults, the central bank can access the pledged collateral and sell it in the market to cover its losses. Conservatively calibrated haircuts on the market value of pledged assets ensure that a sufficient amount of collateral is almost always available to cover losses. Haircuts are higher for more volatile, longer duration, and more credit-risky claims. For example, so-called non-marketable assets carry valuation haircuts of up to 65%. As a result, historical counterparty-level LGDs have been approximately zero for most central banks.

The case of Lehman Brothers can serve as an (extreme) example. Its German subsidiary, Lehman Brothers Bankhaus, defaulted on the Eurosystem on 15 September 2008. In the weeks leading up to the default, a large quantity of mortgage-backed-securities had been posted as collateral that were highly non-liquid and non-marketable at the time. In addition,

<sup>8</sup> Other models to quantify a central bank's portfolio credit risks exist. For central-bank-specific through-the-cycle models of portfolio credit risk see e.g. [ECB \(2007, 2015\)](#). Our model measures credit risk at an uncommonly high frequency based on point-in-time risk measures. This is necessary given the questions at hand; see [Section 4](#). For a discussion of model selection see [Section 4.1](#).

<sup>9</sup> The  $\tau_{it}$ 's are not required at the estimation stage, and are constructed afterwards.



an untypically large amount of central bank liquidity had been withdrawn just prior to the default. Even so, the posted collateral was ultimately sufficient to recover all losses. The workout-LGD was zero as a result; see Bundesbank (2015).

A substantial loss to the central bank may nevertheless occur in extreme scenarios when both banks and their collateral default simultaneously. This was a valid concern during the sovereign debt crisis. A subset of banks pledged bonds issued by their domestic government, or bank bonds that were eligible only because they were also government-guaranteed. This exposed the central bank to substantial “wrong way risk,” as bank and sovereign risks are highly positively dependent in the data.

We incorporate the above observations as follows. For a bank counterparty  $i$ , we model LGD stochastically as

$$\text{LGD}_{i,t+1:t+52} = 0.02 + 0.58 \cdot 1\{\tilde{y}_{jt} < \tau_{jt} \text{ for at least one SMP country } j\}. \quad (5)$$

i.e.,  $\text{LGD}_{i,t+1:t+52} = 0.02$  if bank counterparty  $i$  defaults but no SMP counterparty defaults. The 2% value for bank workout LGDs is not unrealistically low, as explained above. The LGD increases to 60% if bank  $i$  defaults and at least one SMP sovereign defaults as well (in the same simulation).<sup>10</sup> The 60% value reflects the conservative assumption that a sovereign credit event could be associated with significant spillovers across all euro area banks and sovereigns, leading to an impaired market value for all posted collateral.<sup>11</sup> The 60% stressed LGD is furthermore approximately in line with international evidence on government bond haircuts (Cruces and Trebesch, 2013, Table 1), (Moody's, 2018, p. 8)'s long-horizon LGD estimates for senior unsecured bonds, and the Foundation-IRB approach as referred to in the E.U.'s CRR (2013).

In case of a sovereign counterparty, e.g., for government bonds acquired within the SMP, only a single recourse applies. We set the LGD to 60% should such a default be observed,

$$\text{LGD}_{j,t+1:t+52} = 0.60 \cdot 1\{\tilde{y}_{jt} < \tau_{jt} \text{ for SMP country } j\}. \quad (6)$$

More elaborate specifications for LGD are clearly also possible. The present approach, however, is parsimonious and conservative, while still sufficiently flexible to capture the issues of systematic variation of LGDs with defaults as well as wrong-way risk between banks and sovereigns.

Exposures-at-default  $\text{EAD}_{i,t+1:t+52}(k)$  in (1) can, but do not have to, coincide with currently observed exposure  $\text{EXP}_{it}(k)$ . Recall that in the case of Lehman Brothers Bankhaus, exposures increased substantially in the weeks prior to the observed default. Similarly, the OMT would likely be activated in extremely bad states of the world. To keep things simple and interpretable, however, we set  $\text{EAD}_{i,t+1:t+52}(k) = \text{EXP}_{it}(k)$ , also in line with the static balance sheet assumption in Section 3.1. We refer to Web Appendix C for further details.

## 4. Empirical results

Our empirical study is structured around five interrelated questions. What were the relevant portfolio credit risks associated with each Eurosystem unconventional monetary policy operation during the sovereign debt crisis? How important were risk spillovers across different monetary policy operations? Were the tail risks at all times covered by financial buffers? To what extent did unconventional policies differ in terms of ex-post risk efficiency? Finally, do other central banks' policy announcements materially affect the Eurosystem's risks?

### 4.1. Model specification

For model selection, we are most interested in whether non-Gaussian dependence as well as the asymmetry term in (4) are preferred by the data. Table 1 reports parameter estimates for three different specifications of the copula model (3)–(4). The model parameters are estimated from  $D = 9 + 5 = 14$  multivariate time series of daily log changes in banking sector and sovereign EDFs. Univariate Student's  $t$  models with time-varying volatility and leverage are used to model the marginal dynamics for each series separately; see Web Appendix C.

Gaussian dependence is a special case of our model, with  $\nu^{-1} = 0$  and  $C = 0$ . This joint restriction, however, is strongly rejected by the data in a likelihood-ratio test.<sup>12</sup> Turning to the two  $t$  copula specifications, allowing for an asymmetric response of the correlation factors is preferred by the data based on the log-likelihood fit and information criteria. The increase in log-likelihood is significant at the 5% level. This model choice has an economically small effect on the expected shortfall estimates, and almost no effect on the mean loss estimates. The degree-of-freedom parameter  $\nu \approx 12$  allows for a moderate degree of joint tail dependence in the copula.<sup>13</sup> Parameter  $C < 0$  implies that correlations increase more quickly in bad times than they decrease in good times.<sup>14</sup> Experimenting with block-specific  $C$  parameters did not lead to significantly

<sup>10</sup> The multivariate model allows the defaults of banks and sovereigns to be positively correlated. As a result, the adverse feedback loop between banks and sovereigns does not just work through 5.

<sup>11</sup> Web Appendix E.2 explores what happens to portfolio credit risk if a less conservative LGD specification is adopted. While the multivariate risk model is nonlinear in parameters, its implied EL and ES99% estimates are linear in LGD; see (1).

<sup>12</sup> Web Appendix E.1 presents and discusses EL and ES99% estimates based on the simpler Gaussian model.

<sup>13</sup> The degree-of-freedom parameters  $\nu$  for the marginal univariate models are substantially lower, and vary between approximately three and eight; see Web Appendix D. The Web Appendix further reports diagnostic checks for all  $D$  marginal models. The diagnostic checks are in line with the substantial increase in log-likelihood fit when moving from Gaussian to Student's  $t$  models.

<sup>14</sup> This is related to the use of polar coordinates (cosines) when mapping  $f_t$  into  $\Sigma_t$ ; see Web Appendix C.

**Table 1**

Parameter estimates for the copula model (3)–(4) fitted to weekly log changes in  $D = 14$  banking sector and sovereign EDFs between 03 October 2008 and 11 March 2016 ( $T = 389$ ). The same univariate models are used; see Web Appendix C. The first model specification enforces a multivariate Gaussian copula by setting  $C = 0$  and  $\nu^{-1} = 0$ . The second and third specifications refer to a symmetric and asymmetric  $t$  copula, respectively. Standard errors in parentheses are constructed from the numerical second derivatives of the log-likelihood function.

	Gaussian copula	Student's $t$ copula	
		symmetric ( $C = 0$ )	asymmetric ( $C \neq 0$ )
A	0.007 (0.003)	0.007 (0.003)	0.008 (0.002)
B	0.864 (0.082)	0.953 (0.034)	0.969 (0.013)
C	-	-	-0.555 (0.206)
$\nu$	-	11.964 (0.991)	11.970 (0.982)
logLik	1487.61	1629.49	1631.83
AICc	-2969.2	-3251.0	-3253.6

improved log-likelihoods. We select the asymmetric  $t$  copula specification for the remainder of the analysis based on likelihood fit and information criteria. Using this specification, we combine model parsimony with the ability to explore a rich set of questions given the data at hand.

#### 4.2. Expected shortfall

A large number of studies focus on the beneficial impact of Eurosystem unconventional monetary policies during the euro area sovereign debt crisis on financial markets and macroeconomic outcomes, including Eser and Schwaab (2016), Ghysels et al. (2017), Krishnamurthy et al. (2018), Fratzscher and Rieth (2018), De Pooter et al. (2018), among many others. By contrast, the risk implications and potential downsides of unconventional policies have received less attention.

Fig. 4 plots estimated one-year-ahead ES99% from Eurosystem collateralized lending operations (top panel) and SMP asset purchases (bottom panel). Portfolio-specific estimates are (sub)additive across operations, and stacked vertically in the top panel of Fig. 4. The loss density is obtained by simulation, using 200,000 draws at each time  $t$ ; see Web Appendix C.6 for details. For each simulation, we keep track of exceedances of  $\tilde{y}_{it}$  below their respective calibrated thresholds at time  $t$  as well as the outcomes for LGD and EAD, as described in Section 3. The risk estimates combine all exposure data, marginal risks, as well as all  $14(14-1)/2=91$  time-varying correlation estimates into a single time series per operation.

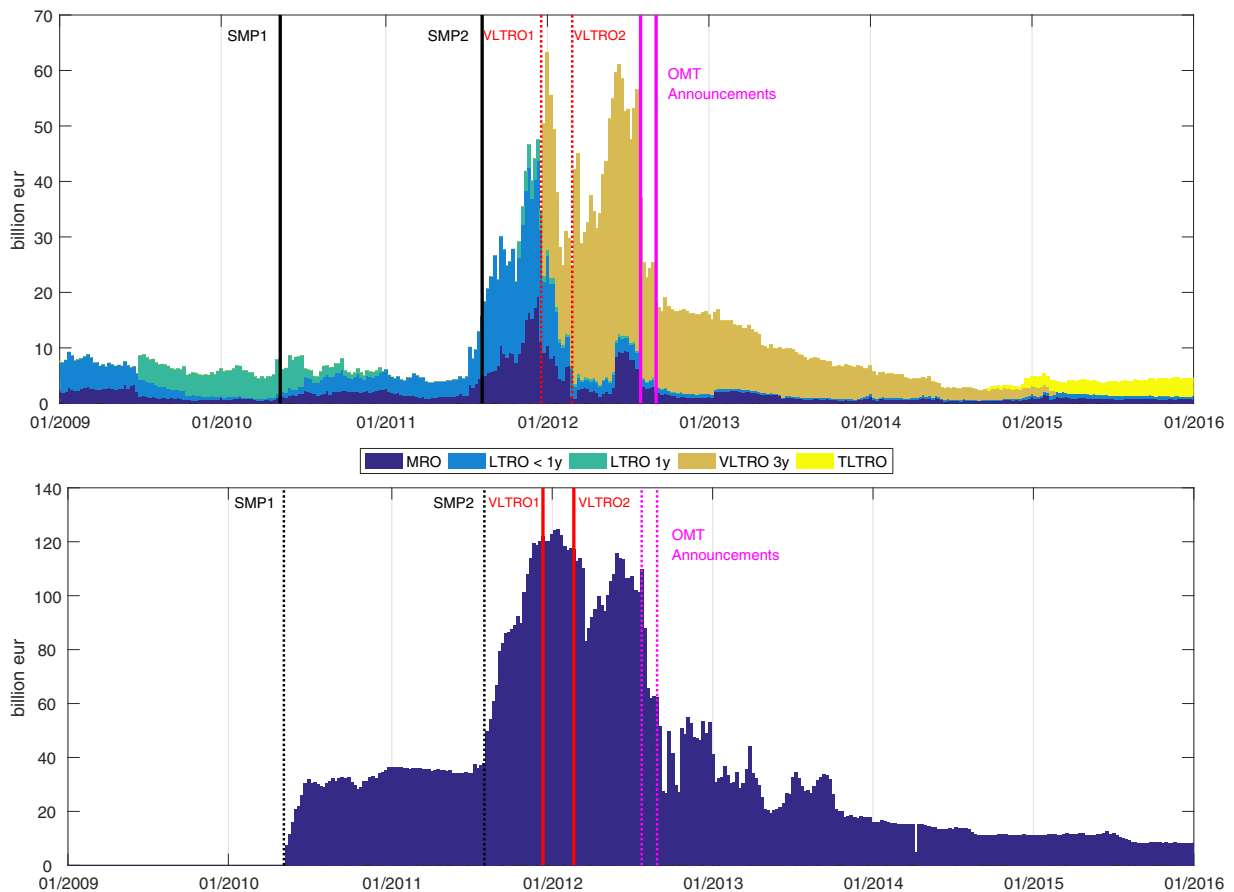
The ES99% estimates in Fig. 4 exhibit pronounced time series variation, peaking in 2012 at approximately € 60 bn for the collateralized lending operations and at approximately € 120 bn for the SMP portfolio. All portfolio tail risks collapse sharply following the OMT announcements.<sup>15</sup>

Fig. 5 provides the ES99% scaled per € 1. The changes in portfolio credit risks around key policy dates can be decomposed into a risk (PD and correlation) component and an exposure component. Fig. 5 suggests that the risk component is the main driver. For example, the ES99% decreases from approximately 55 cent per € 1 of SMP exposures before the allotment of the first VLTRO to less than 40 cent following the allotment of the second VLTRO. As another example, the ES99% collapses from approximately 50 cent per € 1 of SMP exposures before the OMT announcements in mid-2012 to less than 20 cent per € 1 afterwards. Regarding collateralized lending, the ES99% decreases from approximately 4.5 cent per € 1 of exposures before the OMT announcements to less than 2 cents following the second announcement.

When comparing the top and bottom panels of Fig. 5, portfolio risk per € 1 of exposure differs by approximately one order of magnitude. The risk differential between collateralized lending and outright holdings is even more pronounced at the center of the loss distribution; see Web Appendix F. Such pronounced differences in portfolio risk may be relevant for the decision whether to provide additional central bank liquidity via collateralized lending operations or via outright asset purchases. Implementing monetary policy via credit operations could be preferable in settings when the respective economic benefits are comparable.

Finally, Figs. 4 and 5 strongly hint at the presence of beneficial spillovers across monetary policy operations. For example, the OMT announcements had a pronounced impact on the ES99% associated with the collateralized lending and the SMP asset portfolios. As another example, the weeks around the first VLTRO allotment coincide with peak SMP ES99% in percent of exposures.

<sup>15</sup> To the extent that redenomination risk is priced in sovereign CDS contracts, redenomination risk is a part of the portfolio credit risks as plotted in Figs. 4 and 5. Redenomination risk is most likely relevant for the SMP portfolio; the collateralized lending portfolios may be sensitive to redenomination risk via the LGD specification (5).



**Fig. 4.** ES99 for collateralized lending and SMP portfolios Top panel: ES99 in € bn for five Eurosystem collateralized lending operations. Bottom panel: ES99 for SMP asset portfolio. Six vertical lines mark the events described in Section 2. Data is weekly between 2009 and 2015.

#### 4.3. Financial buffers

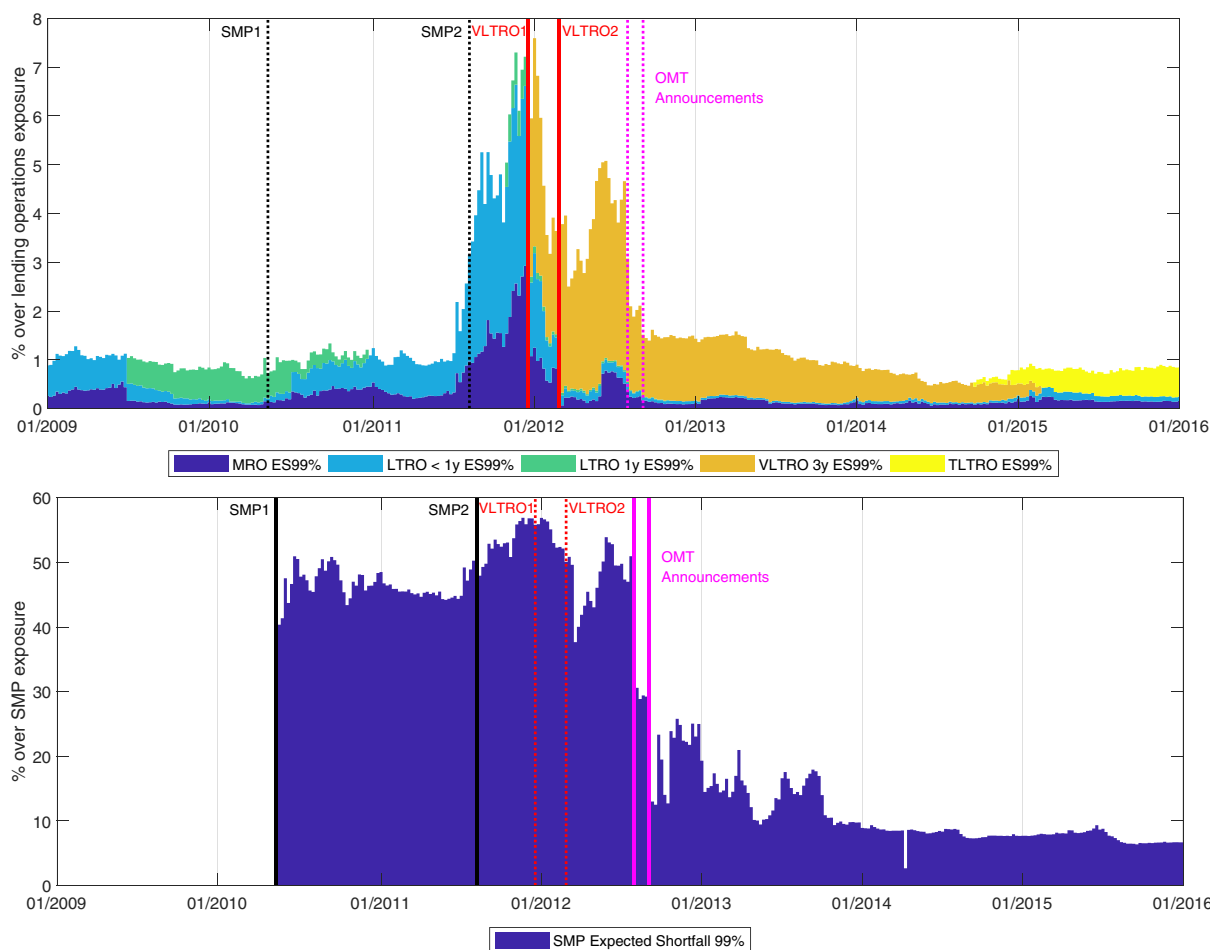
This section studies whether the Eurosystem was at all times sufficiently able to withstand the materialization of a 99% ES-sized credit loss.

For a commercial bank, financial buffers against a large portfolio loss typically include accounting items such as the current year's projected annual income, revaluation reserves in the balance sheet, general risk provisions, and paid-in equity capital. We adopt a similar notion of financial buffers for the Eurosystem. We recall, however, that a central bank is never liquidity constrained in the currency they issue, so that the notion of solvency buffers is much less appropriate.

Since the financial crisis in 2008, the Eurosystem as a whole has built up relatively large financial buffers, including from part of the stream of seignorage revenues generated by banknote issuance. Those buffers are mainly in the form of capital and reserves (i.e., paid-up capital, legal reserves and other reserves), revaluation accounts (i.e., unrealized gains on certain assets like gold) and risk provisions. These items stood at € 88 bn, € 407 bn and € 57 bn, respectively, at the end of 2012; see (ECB, 2013, p. 44). The overall financial buffers therefore stood at € 552 bn. Comparing these balance sheet items with our ES estimates in Fig. 4 we conclude that the Eurosystem's aggregate buffers were at all times sufficient to withstand an ES99%-sized credit loss, even at the mid-2012 peak of the euro area sovereign debt crisis.

#### 4.4. Risk spillovers across policy operations

The credit risk of the Eurosystem's balance sheet depends on the financial health of its counterparties, which in turn depends on expectations about the central bank's liquidity provision to and asset purchases from those same counterparties. This interdependence can give rise to a pronounced nonlinearity in the central bank balance sheet risks, e.g. as the economy switches from a 'bad' equilibrium to a 'good' one; see e.g. Calvo (1988), Reis (2013), and ECB (2014). This section studies how a central bank's credit risk respond to the announcement (and subsequent implementation) of unconventional monetary policies.



**Fig. 5.** ES99% in percent of exposures Top panel: ES99% for five collateralized lending portfolios in percent of total collateralized exposures, stacked vertically. Bottom panel: ES99% for SMP assets in percent of total nominal (par) value. The vertical lines mark the events described in Section 2. Data is weekly between 2009 and 2015.

The high (weekly) frequency of the risk estimates plotted in Fig. F.1 and 4 allow us to identify the impact of certain key ECB policy announcements. Table 2 presents standard portfolio risk estimates shortly before and after six key policy announcements.

We obtain the following main findings. First, LOLR- and IOLR-implied credit risks are usually negatively related in our sample. Taking risk in one part of the central bank's balance sheet (e.g., the announcement of SMP asset purchases in May 2010) tended to de-risk other positions (e.g., collateralized lending from previous LTROs, by approximately € 2.2 bn). Vice versa, the allotment of the two large-scale VLTRO credit operations each decreased the expected shortfall of the SMP asset portfolio (by € 2.1 bn and € 3.3 bn, respectively). This negative relationship strongly suggests that central bank risks can be nonlinear (concave) in exposures. The increase in balance sheet size increased overall credit risk less than proportionally, and by less than one would have expected at unchanged PD and risk dependence parameters. As a result, increasing balance sheet size during a financial crisis is unlikely to increase risk by as much as one would expect from linearly scaling up current portfolio risks with future exposures. Similarly, in the context of ultimately unwinding balance sheet positions, reducing the size of the balance sheet after the crisis may not reduce total risk by as much as one would expect from linear scaling. Arguably, the documented risk spillovers call for a measured approach towards reducing balance sheet size after the crisis has passed.

Second, a subset of unconventional monetary policies reduced (rather than added to) overall balance sheet risk. For example, the first OMT announcement de-risked the Eurosystem's balance sheet by € 41.4 bn (99%-ES). The announcement of OMT technical details on 06 September 2012 was also associated with a strong further reduction of € 18.1 bn in 99% ES. As another example, the allotment of the first VLTRO in December 2011 raised the 99% ES associated with VLTRO lending from zero to approximately € 27.6 bn. However, it also sharply reduced the need for shorter-term MRO and LTRO funding, reducing exposures for these portfolios. In addition, financial sector point-in-time PDs declined as banks were awash in cash

**Table 2**

Portfolio credit risks around six key policy announcements, I/II Portfolio credit risks for different monetary policy operations around six policy announcements: the SMP announcement on 10 May 2010, the cross-sectional extension of the SMP on 08 August 2011, and the allocation of the first VLTRO on 20 December 2011. Square brackets [ ] contain 99% confidence intervals obtained from 200,000 simulation runs. Web Appendix G presents the analogous results in percent of the respective exposures. The table continues on the next page.

SMP1	07/05/2010		14/05/2010		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	0.0	0.0	0.3	7.3	0.3	7.3
	[0.0 0.0]	[0.0 0.0]	[0.3 0.3]	[7.3 7.4]		
MRO	0.0	1.1	0.0	1.0	0.0	-0.1
	[0.0 0.0]	[0.9 1.2]	[0.0 0.0]	[0.8 1.0]		
LTRO < 1y	0.0	0.6	0.0	0.5	-0.0	-0.1
	[0.0 0.0]	[0.5 0.7]	[0.0 0.0]	[0.5 0.6]		
LTRO1y	0.2	6.2	0.2	4.1	-0.0	-2.1
	[0.2 0.2]	[5.1 6.4]	[0.2 0.2]	[4.1 4.7]		
Total	0.2	7.9	0.5	13.0	0.3	5.1
SMP2	05/08/2011		12/08/2011		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	5.2	38.0	6.7	49.9	1.5	11.9
	[5.2 5.2]	[37.7 38.2]	[6.7 6.8]	[49.3 50.1]		
MRO	0.1	4.5	0.1	4.8	0.0	0.4
	[0.1 0.1]	[4.0 4.8]	[0.1 0.1]	[4.2 5.5]		
LTRO < 1y	0.2	8.5	0.3	10.9	0.0	2.4
	[0.2 0.2]	[7.0 9.2]	[0.2 0.3]	[9.0 11.1]		
Total	5.5	51.0	7.1	65.6	1.5	14.7
VLTRO1	16/12/2011		30/12/2011		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	26.8	122.2	25.3	120.1	-1.5	-2.1
	[26.7 26.9]	[121.9 122.5]	[25.3 25.4]	[119.4 120.4]		
MRO	0.3	19.3	0.2	9.1	-0.1	-10.2
	[0.3 0.3]	[17.7 21.3]	[0.2 0.2]	[8.5 10.0]		
LTRO < 1y	0.5	24.4	0.3	12.8	-0.2	-11.5
	[0.5 0.5]	[21.3 24.7]	[0.3 0.3]	[12.0 13.6]		
LTRO1y	0.1	3.9	0.0	1.0	-0.0	-2.9
	[0.1 0.1]	[3.5 4.1]	[0.0 0.0]	[0.9 1.0]		
VLTRO3y	0.0	0.0	0.5	27.6	0.5	27.6
	[0.0 0.0]	[0.0 0.0]	[0.4 0.5]	[26.0 28.8]		
Total	27.7	169.8	26.3	170.6	-1.4	0.8

following the first VLTRO allotment. Finally, and importantly, the VLTRO allotment also de-risked the SMP asset portfolio, as banks funneled some of the additional liquidity into government bonds (Acharya and Steffen, 2015; Drechsler et al., 2016), alleviating stressed sovereigns' funding stress. As a result, the overall 99% ES increased, but only minimally so, by € 0.8 bn. Expected losses declined by € 1.4 bn. We conclude that, in extreme conditions, a central bank can de-risk its balance sheet by doing *more*.

Such risk reductions are not guaranteed, however. In particular the SMP2 announcement is an exception to the patterns described above; see Table 2. The extension of the program to include Spain and Italy in August 2011 did not reduce the credit risks inherent in the collateralized lending book. It also did not lead to a reduction in total risk. This exception is probably related to the pronounced controversy regarding the extension of the SMP at that time. The controversy as well as the related communication challenges may have caused market participants to doubt that the SMP would be large and active for long, thus lessening its economic and risk impact.

Third, portfolio risk estimates as reported in Figs. 4 and 5 are a prerequisite for evaluating policy operations in terms of their "risk efficiency." Risk efficiency is the principle that a certain amount of expected policy impact should be achieved with a minimum level of balance sheet risk; see e.g. ECB (2015). Put differently, the impact of any policy operation should be maximal given a certain level of risk. Given an estimate of policy impact, such as, for example, a change in inflation swap rates or in bond yields around the time of a policy announcement, and given an estimate of additional risk, such as, for example, a change in expected shortfall, different policy operations can be evaluated by scaling the former by the latter. Web Appendix H reports our respective findings. To summarize, we find that the first round of SMP purchases in 2010 was more risk efficient than the second round following the SMP's extension to include Italy and Spain in 2011. The first VLTRO allotment was more risk efficient than its second allotment. The OMT program was particularly risk efficient ex-post.

**Table 3**

Portfolio credit risks around six key policy announcements, II/II Portfolio credit risks for different monetary policy operations around six policy announcements (continued): the allocation of the second VLTRO on 20 February 2012, the OMT announcement on 02 August 2012, and the announcement of the OMT's technical details on 06 September 2012. Square brackets [] contain 99% confidence intervals obtained from 200,000 simulation runs. Web Appendix G presents the analogous results in percent of the respective exposures.

VLTRO2	24/02/2012		09/03/2012		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	30.2 [30.1 30.2]	117.2 [116.1 118.3]	30.2 [30.2 30.3]	113.9 [112.2 114.5]	0.0	-3.3
MRO	0.2 [0.1 0.2]	6.7 [6.5 7.2]	0.0 [0.0 0.0]	0.7 [0.7 0.8]	-0.1	-6.0
LTRO < 1y	0.1 [0.1 0.1]	5.2 [4.6 5.4]	0.1 [0.1 0.1]	2.3 [2.0 2.4]	-0.1	-2.9
LTRO1y	0.0 [0.0 0.0]	0.5 [0.5 0.6]	0.0 [0.0 0.0]	0.6 [0.5 0.6]	0.0	0.1
VLTRO3y	0.3 [0.3 0.3]	17.3 [15.1 19.0]	0.6 [0.6 0.6]	38.6 [34.1 39.3]	0.3	21.3
Total	30.8	147.0	31.0	156.1	0.2	9.1
OMT1	27/07/2012		03/08/2012		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	21.5 [21.4 21.5]	109.8 [107.9 110.4]	19.8 [19.8 19.9]	87.8 [85.8 88.6]	-1.7	-22.0
MRO	0.2 [0.2 0.2]	6.2 [5.4 6.7]	0.2 [0.2 0.2]	4.5 [3.9 4.7]	-0.0	-1.8
LTRO < 1y	0.1 [0.1 0.1]	2.9 [2.7 3.5]	0.1 [0.1 0.1]	1.9 [1.9 2.4]	-0.0	-1.1
LTRO1y	0.0 [0.0 0.0]	0.4 [0.4 0.4]	0.0 [0.0 0.0]	0.3 [0.3 0.3]	-0.0	-0.1
VLTRO3y	1.0 [0.9 1.0]	47.0 [38.3 47.7]	0.8 [0.8 0.8]	30.5 [29.4 33.8]	-0.2	-16.5
Total	22.8	166.4	20.9	125.0	-1.9	-41.4
OMT2	31/08/2012		07/09/2012		$\Delta$ EL	$\Delta$ ES99%
	EL	ES99%	EL	ES99%		
SMP	15.8 [15.7 15.8]	62.4 [61.0 63.0]	14.5 [14.4 14.5]	51.5 [51.1 52.5]	-1.3	-10.8
MRO	0.2 [0.2 0.2]	3.1 [2.4 2.9]	0.1 [0.1 0.1]	2.0 [1.8 2.1]	-0.0	-1.1
LTRO < 1y	0.0 [0.0 0.1]	1.3 [1.1 1.4]	0.0 [0.0 0.0]	1.0 [0.9 1.1]	-0.0	-0.3
LTRO1y	0.0 [0.0 0.0]	0.2 [0.2 0.2]	0.0 [0.0 0.0]	0.2 [0.1 0.2]	-0.0	-0.1
VLTRO3y	0.7 [0.6 0.7]	20.9 [18.7 21.7]	0.5 [0.5 0.6]	15.0 [14.7 16.2]	-0.1	-5.9
Total	16.6	87.8	15.2	69.7	-1.5	-18.1

Finally, monetary policy-related announcements of *other* central banks could in principle spill over and affect the Eurosystem's risks via an impact on its counterparties. For example, the Federal Reserve's announcement to 'taper off' asset purchases in May 2013, or the announcement by the Swiss National Bank to unpeg the Swiss Franc from the Euro in January 2015, could have had a discernible impact on the Eurosystem's portfolio credit risks via an impact on the euro area financial sector or its risk correlations with sovereigns. We do not find economically large effects when studying a small but relevant set of such announcements; see Web Appendix I for details.

## 5. Conclusion

We introduced a tractable framework to measure central bank balance sheet risks at a high frequency and applied it to all major Eurosystem unconventional monetary policy operations during the euro area sovereign debt crisis between 2010 and 2012. Our results suggest that central banks can influence their credit risks, particularly when they act as lenders- and investors-of-last-resort during turbulent times. They can use this to their advantage when implementing monetary policy in a risk-efficient way. For instance, though increasing the amount of central bank liquidity in the financial system for monetary policy purposes can be achieved via both credit operations and asset purchases, we find that collateralized credit operations imply substantially less credit risks per unit of liquidity provision, often by an order of magnitude. In short, our findings that

central banks can influence their own credit risks in turbulent times give some, albeit not complete, support to Bagehot's famous conjecture that occasionally "only the brave plan is the safe plan."

## Supplementary material

Supplementary material associated with this article can be found, in the online version, at doi:[10.1016/j.jmoneco.2019.11.003](https://doi.org/10.1016/j.jmoneco.2019.11.003).

## CRedit authorship contribution statement

**Diego Caballero:** Conceptualization, Data curation, Formal analysis, Investigation, Visualization, Writing - original draft, Writing - review & editing. **André Lucas:** Investigation, Methodology, Software, Supervision, Validation, Writing - review & editing. **Bernd Schwaab:** Conceptualization, Data curation, Investigation, Project administration, Resources, Writing - original draft, Writing - review & editing. **Xin Zhang:** Formal analysis, Investigation, Methodology, Software, Writing - review & editing.

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