

The implementation of the ESCB's monetary policy by the Bundesbank and its formulation in the General Terms and Conditions

Upon entry into stage three of European monetary union on January 1, 1999, responsibility for monetary policy will be transferred to the Community level. Monetary policy in the participating countries will then be conducted on the basis of a new, uniform set of monetary policy instruments, and the current national instruments will cease to be in force. As before, the refinancing of the credit institutions will continue to be undertaken by the national central banks. The Governing Council of the European Central Bank adopted a guideline on this ("General documentation") which had to be implemented by the national central banks. In this connection, the national central banks were also required to take decisions on implementation. The Bundesbank has implemented this guideline by amending its General Terms and Conditions.

The Bundesbank's tasks within the ESCB

In future, monetary policy will be determined at the Community level. The European System of Central Banks (ESCB) has been established for this purpose. It comprises the European Central Bank (ECB) and the national central banks of the participating member states. The ESCB is governed by the decision-making bodies of the European Central Bank (Governing Council and Executive Board). The ECB Governing Council defines the single monetary policy of the Community and

*Integral part of
the ESCB*

adopts the guidelines and takes the decisions necessary for its implementation. The President of the Bundesbank takes part in all fundamental monetary policy decisions in the Governing Council of the ECB. The national central banks are an integral part of the ESCB and implement its monetary policy in the respective member states. Accordingly, the future wording of section 3 of the Bundesbank Act, which was revised by the Sixth Act Amending the Bundesbank Act of December 22, 1997 (Federal Law Gazette I, page 3274), reads as follows:

“The Deutsche Bundesbank, being the central bank of the Federal Republic of Germany, is an integral part of the European System of Central Banks (ESCB). It shall participate in the performance of the ESCB’s tasks with the primary objective of maintaining price stability, and shall arrange for the execution of domestic and international payments.”

Moreover, the provisions of the Bundesbank Act concerning the Bundesbank’s set of monetary policy instruments have been repealed with effect from January 1, 1999 (section 15 on discount, lending and open market policies, and section 16 on minimum reserve policy).

Article 12.1 of the ESCB Statute provides that, to the extent deemed possible and appropriate, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB. Accordingly, the ECB Governing Council has now stipulated that the monetary policy it has defined (apart from fine-tuning oper-

ations in exceptional cases) is to be implemented in a very largely decentralised manner by the national central banks.

The main task in meeting the ESCB’s primary objective of maintaining price stability is to define and implement the monetary policy of the Community. Associated with this is another task of the ESCB, which is to promote the smooth operation of payment systems.

These two areas of responsibility required, to a particular degree, an adaptation of the General Terms and Conditions of the Deutsche Bundesbank. In its initial meetings, the Governing Council of the ECB adopted, inter alia, the operational framework for monetary policy and the basic conditions for the new EMU payment system TARGET (Trans-European Automated Real-Time Gross settlement Express Transfer). In doing so, the Governing Council based its decisions on the preliminary work undertaken by the European Monetary Institute (EMI). In cooperation with representatives of the central banks of the EU member states, EMI had prepared the publication “General documentation on ESCB monetary policy instruments and procedures” of September 1997 (also widely known as “General documentation”), which laid the groundwork for the set of monetary policy instruments. A cross-check of the implementation procedure to be followed by the individual national central banks which was performed by the specialist bodies of the ESCB has revealed that nine of the eleven participating countries are taking a purely contractual approach to the implementation of the monetary policy through foreign ex-

*Adaptation of
the General
Terms and
Conditions to
the require-
ments of the
ECB*

*Decentralised
discharge of
duties in the
ESCB*

change policy operations. In some cases, this approach is set out in General Terms and Conditions and, in others, enshrined in model agreements based on the respective national legislation. Maintaining the tradition applying to its central bank operations and throughout the German banking industry, the Bundesbank has formulated the details of the legal framework in General Terms and Conditions.

General Terms and Conditions and monetary policy operations

General Terms and Conditions as the basis of monetary policy operations

The following sections first deal with the adjustment of monetary policy operations governed by the General Terms and Conditions of the Deutsche Bundesbank ("Green Book"). Subsequently, changes associated with ECB requirements for the payment system TARGET and with the introduction of the euro will be discussed. The sovereign minimum reserve instruments (which, as is generally known, will also exist in the ESCB in a somewhat altered form) and the collection of statistical data will not be discussed in further detail in the present analysis of the General Terms and Conditions which apply at the level of private law.

Open market transactions and "standing facilities"

The Bundesbank's refinancing policy has hitherto been based mainly on discount and lombard business and on open market transactions in the form of securities repurchase agreements. In future, discount business, i. e. the purchase of bills at a preferential interest rate (discount rate), will cease to apply (although the trade bill can be used as collateral). The monetary policy operations of the

ESCB are subdivided into "open market transactions" and "standing facilities" (see General Terms and Conditions of the Deutsche Bundesbank, part V nos. 2, 23 ff.).

In open market transactions, the ESCB will take the initiative with regard to refinancing, with the respective national central bank being responsible for implementation. In this context, the "main refinancing operations" in the form of regular weekly standard tenders (variable and fixed-rate tenders), each with a maturity of two weeks, are of paramount importance. These transactions correspond to the existing securities repurchase agreements of the Bundesbank. In parallel with these main refinancing operations, "longer-term refinancing operations" can be applied (usually in the form of variable-rate tenders), which are normally renewed at monthly intervals and have a maturity of three months each. In terms of the longer maturity, they correspond to the existing rediscount credit line and play a part in steadying the money market.

"Main refinancing operations" and "longer-term refinancing operations"

Additionally, "fine-tuning operations" with a limited range of counterparties and with no standardised maturity can play a supplementary role, especially in the event of unexpected liquidity fluctuations in the market. Such operations may include, for the provision of liquidity, reverse tender operations (in the form of quick tenders, i. e. tenders executed within a very short period of time), foreign exchange swaps, and outright purchases of securities and other assets. For absorption of liquidity, they may include foreign exchange swaps, the collection of fixed-term deposits with a fixed maturity and fixed inter-

Fine-tuning operations

est rates (new for the Bundesbank), securities repurchase agreements (sale and repurchase of securities from the Bundesbank's own holdings), and outright sales.

Structural operations

In addition, "structural operations" without standardised maturity may be applied. Depending on the situation, they are primarily conducted in order to adjust the structural liquidity situation of the financial sector vis-à-vis the ESCB. Such operations may include, for the provision of liquidity, reverse tender operations and/or outright purchases of securities or other assets, and for absorption of liquidity, the issue of short-term discounted ECB debt securities by standard tender, and outright sales.

Standing facilities

The above-mentioned open market transactions are supplemented by what are known as standing facilities where the initiative for concluding transactions lies with the commercial banks. There are two types of standing facilities, namely the "marginal lending facility" and the "deposit facility" (see General Terms and Conditions of the Deutsche Bundesbank, part V nos. 31 and 32). The marginal lending facility, which is called overnight credit at the Bundesbank, will take the place of the lombard loan and grant liquidity to the requested amount at a predetermined rate of interest with a maturity in each case of one business day, i. e. overnight. An account overdraft existing at the end of a business day is deemed to be a request for taking up an overnight credit to the amount overdrawn; uncovered end-of-day debit balances are thus transferred automatically to the over-

Marginal lending facility (overnight credit)

night credit, as with the existing giro overdraft lombard loan.

In the case of the deposit facility, which is another new monetary policy instrument for the Bundesbank, the counterparties may lodge surplus credit balances with the Bundesbank "overnight", until the start of the next business day, as deposits carrying a predetermined rate of interest. Thus, apart from the possibility of covering liquidity requirements overnight by taking up an overnight credit at short notice, counterparties may, alternatively, take advantage of the standing facility of lodging liquidity surpluses at interest with the central bank for a short period of time.

Deposit facility

In a way, the standing facilities' interest rates form an interest rate channel: the interest rate on the overnight credit generally provides a ceiling for the overnight interest rate of the interbank money market, while the interest rate on the deposit facility marks the floor. The "key interest rate" of the most important refinancing instrument, the "main refinancing operation", moves within the aforementioned interest rate channel and will be oriented to the overnight market interest rate.

Structure of the interest rates

All open market lending transactions and both overnight credit and account overdrafts during the business day must be covered by adequate underlying assets provided by the commercial banks. Accordingly, the "General documentation" contains specific provisions on the types of eligible assets, their valuation and the collateral procedures, which have had to be incorporated into the new General Terms and Conditions of the Deutsche

Adequate collateral

Bundesbank (see General Terms and Conditions of the Deutsche Bundesbank, part V nos. 3 and 4).

*Types of
underlying
assets*

Accordingly, the Deutsche Bundesbank will accept as underlying assets

- securities mentioned in lists published by the ECB,
- trade bills, and
- claims arising from loans granted by the commercial banks to eligible borrowers (non-bank enterprises or self-employed persons).

The acceptance of trade bills and loan claims as eligible assets (the latter being something completely new for the Bundesbank) aims at placing central bank credit to as wide an extent as possible on a real economic basis.

*Valuation of
the underlying
assets*

The individual assets provided by a counterparty will be credited to his "pledge account" at their respective loan value (gross value less valuation haircuts calculated on the basis of general risk considerations) and yield the total loan value. The valuation haircuts depend on the type of assets: in the case of securities, they range between 0 % and 5 % depending on their maturity, and they amount to 2 % in the case of trade bills and 20 % for loan claims. In the event of a change in their collateral holdings, the counterparties will be notified of the total loan value and the loan value which is still at their disposal for collateral purposes. This enables the commercial banks always to be in a position to use their asset holdings and/or conduct their operations with the central bank.

Initial margins

A further risk control measure has to be borne in mind, however, namely what are

known as initial margins: the share of the transaction value required as additional collateral is 1 % for overnight credits, and generally 2 % for open market loans.

The provisions of the ECB in the General documentation left it to the discretion of the national central banks to decide on the legal option they wished to adopt for providing collateral through the above-mentioned assets, taking due account of their national legislation: full transfer of rights based on repurchase agreements and the assignment of claims, on the one hand, or pledging of the assets, on the other; a "mixed" solution according to the various assets may therefore also come into consideration. The Bundesbank has opted for a pure pledging solution: all the assets provided are charged with a lien to the Bundesbank's benefit; all collateral is credited at its loan value to a "collateralised account" and thus combined in a pool which serves to collateralise all central bank loans "en bloc".

The Bundesbank has given preference to this pledging solution because it has some advantages over the "repo" solution: the individual assets used as collateral do not have to be assigned substantively or temporally to specific refinancing operations; instead, they can be pooled, with the total loan value on the collateralised account (taking due account of the initial margins) in each case providing the basis on which all refinancing operations are collateralised. Thus, on the basis of the pooling of collateral, each of the assets can be used in full for collateralisation during their time to maturity. Additionally, the counter-

*Pooling of
collateral and
collateralised
account*

*Advantages of
the pledging
solution*

party can make flexible use of the assets and exchange them as long as the total collateral holdings suffice to collateralise all the outstanding central bank loans.

Securities

Two methods of pledging securities are envisaged: inclusion in the "operational safe custody account" carried for the counterparty at the responsible Land Central Bank, and incorporation of securities (to a specific global amount) into the collateral safe custody system of Deutsche Börse Clearing AG (called Xemac), which will enable the commercial banks to use those securities in a very flexible manner (see General Terms and Conditions of the Deutsche Bundesbank, part V nos. 7 and 8).

Trade bills

When pledging trade bills to the Bundesbank (see General Terms and Conditions of the Deutsche Bundesbank, part V no. 9 ff.), it should be borne in mind that the bills must be handed over physically. Upon maturity, the Bundesbank generally takes charge of the bill collection; bills payable to the counterparty himself are returned to him in good time before the date of maturity.

Claims arising from loans

In connection with loan claims pledged by the commercial banks to the Bundesbank (see General Terms and Conditions of the Deutsche Bundesbank, part V no. 19 ff.), it should be pointed out that the pledging of a claim entails a legal requirement to notify the borrower; this notification will be made by the Bundesbank on behalf of the counterparty concerned. The claims arising from loans must also be subject to German law and legally enforceable before a German court.

It should finally be mentioned that commercial banks can also make "cross-border use" of underlying assets from abroad for lending operations with the Bundesbank. Securities are generally required to be delivered to the Bundesbank from either Deutsche Börse Clearing AG or the foreign central bank concerned. For the inclusion of eligible foreign trade bills and claims arising from loans, special terms and conditions of the foreign central bank concerned are applicable (see General Terms and Conditions of the Deutsche Bundesbank, part V no. 22).

Cross-border use of underlying assets

In line with the requirements of the ECB, all the regulations outlined above¹ are reflected in the new part V Monetary policy operations of the General Terms and Conditions of the Deutsche Bundesbank; in this connection, the new "European" nomenclature has also been incorporated.

General Terms and Conditions and EMU payment system

The efficient implementation of monetary policy measures and the allocation of central bank money throughout the future European money market require a sound and efficient large-value payment system for the euro. Such a system will be available from January 4, 1999 in the form of the real-time gross settlement system TARGET.

TARGET

¹ See also Deutsche Bundesbank, Informationsbrief zur Europäischen Wirtschafts- und Währungsunion, No. 9, September 1997, and Deutsche Bundesbank, Informationsbrief zur Europäischen Wirtschafts- und Währungsunion, No. 15, October 1998.

*Interlinking of
the national
payment
systems*

Its operational design as a real-time gross settlement system means that payments will be executed one by one as soon as adequate cover is available, and will therefore be settled with immediate finality. This will enable the ECB, the national central banks and credit institutions to transfer cross-border payments through this system just as quickly and securely from one participant to another as participants are accustomed to doing in their national systems. Following the decentralised approach, TARGET is a network of the individual national real-time gross settlement systems which are connected with each other by means of an "Interlinking component" (communication network and joint facilities and procedures). This ensures that the participants can also make cross-border transfers by using the existing access to their national system.

*Uniform
standards for
the payment
systems
network*

The Bundesbank will be connected to the TARGET system via its real-time gross settlement system *Elektronischer Schalter (ELS)* (electronic counter). This has necessitated a number of relevant amendments to its General Terms and Conditions. On the one hand, this means that the options and conditions for such cross-border TARGET orders have been defined. On the other hand, amendments were also necessary in order to ensure that the participating national systems comply with the ESCB requirements for uniform standards, for example, with regard to access to or settlement of TARGET payments. Those requirements are set out in the relevant regulations governing giro transactions (see General Terms and Conditions of the Deutsche Bundesbank, part II no. 1) and those govern-

ing payment orders in foreign exchange transactions and international business (see General Terms and Conditions of the Deutsche Bundesbank, part X F no. 3).

Above and beyond that, the Bundesbank will restructure and reorganise its range of payment services at the turn of 1998-99. This will likewise be legally implemented by formulating new regulations in the General Terms and Conditions governing giro transactions (see General Terms and conditions of the Deutsche Bundesbank, part II no. 24).

General Terms and Conditions and introduction of the euro

With the start of monetary union on January 1, 1999, the euro will become the single currency of the participating member states. During what is known as the transitional period from January 1, 1999 to December 31, 2001, the national currency units, i.e. Deutsche Mark, franc, lira, etc., will continue to be valid alongside the euro. Until the introduction of euro-denominated banknotes and coins on January 1, 2002, the euro will exist only in the form of scriptural money; the Deutsche Mark will thus remain the sole legal tender in Germany. However, in the transitional period, it will be possible to credit and/or debit an account in euro (see General Terms and Conditions of the Deutsche Bundesbank, part II no. 2 subsection 2 to 4). The conversion rates adopted by the EU Council will be applicable (see General Terms and Conditions of the Deutsche Bundesbank, part I no. 19 subsection 2).

*Euro and
transitional
period*

*Definition of
the existing
currency units*

This means that, for an initial period of three years, the euro (in the form of scriptural money), the national currency units of the member states participating in monetary union, and the currencies of the non-participating member states will be valid simultaneously. In the operations of the Bundesbank governed by its General Terms and Conditions, constant reference is made to different currencies and/or currency units – sometimes including and sometimes excluding the Deutsche Mark. It therefore appeared advisable to make the following distinction between the currency units that will be used during the transitional period:

- “foreign currency” means the currency of a country whose currency is not the euro (e.g. dollar, yen, pound sterling)
- “national currency units” means the currency units of the participating member states (e.g. Deutsche Mark, franc, lira, etc.)
- “foreign national currency units” means all national currency units with the exception of the Deutsche Mark

(see General Terms and Conditions of the Deutsche Bundesbank, part I no. 19 subsection 1).

*Conversion of
the euro*

In addition, a regulation was necessary stipulating that amounts in euro and/or in national currency units are to be converted on the basis of the conversion rates and conversion rules established by Community law, wherever this is required in connection with operations between the Bundesbank and its counterparties (see General Terms and Conditions

of the Deutsche Bundesbank, part I no. 19 subsection 2).

The aforementioned definitions and stipulations in the General Part of the General Terms and Conditions of the Deutsche Bundesbank are important for a large number of regulations governing individual operations, particularly in foreign exchange transactions and international business (e.g. General Terms and Conditions of the Deutsche Bundesbank, part X B no. 8 subsection 2).

In connection with the introduction of the euro, a new section has been incorporated into the General Terms and Conditions of the Deutsche Bundesbank (part X K), which governs the “repatriation” of other EMU member currencies (e.g. franc, lira) by the Bundesbank. Accordingly, the Bundesbank will purchase banknotes in such currency units from the general public, particularly from credit institutions and foreign exchange bureaux, against cash payment of the equivalent in Deutsche Mark, or against credit to the account in Deutsche Mark or euro. The Bundesbank will then pass the money on to the issuing central banks concerned for reimbursement.

The new General Terms and Conditions of the Bundesbank will be published in the Federal Gazette at the end of November 1998 so that they can enter into force at the start of monetary union on January 1, 1999. The “Green Book” will be made available to the Deutsche Bundesbank’s counterparties during December 1998.

*Publication of
the new
General Terms
and Conditions
of the Deutsche
Bundesbank*