Collateral policy surprises

18.8.2026 - Pia Hüttl, Gökhan Ider, Matthias Kaldorf | Deutsche Bundesbank

In this paper, we propose a novel high-frequency identification strategy to study the systematic effects of ECB collateral policy on banks, financial markets and the sovereign bond market. Guided by a simple theoretical framework, our paper exploits the reaction of bank stock prices around ECB policy announcements. We find that expansionary collateral policy reduces bank default risk and compresses the spread between core and periphery sovereign bonds, indicating an entirely different transmission mechanism from that of conventional monetary policy.

Central bank collateral policy in the Eurosystem

Central bank collateral policy specifies which assets banks can pledge to obtain central bank funding. Collateral policy is a powerful central bank instrument as it determines the aggregate liquidity in the banking system. Contrary to conventional wisdom, ECB collateral policy evolves over time and affects several asset classes such as government bonds, corporate bonds and bank loans, while specifying eligibility criteria and haircuts for each asset class. In addition, collateral policy responds endogenously to macro-financial conditions. Taken together, this makes causal identification of its effects particularly challenging.

A novel empirical approach

This paper presents a novel high-frequency identification strategy to isolate collateral policy surprises (CPS). We collect 44 Eurosystem collateral announcements that were made between January 2007 and December 2022. Guided by a simple theoretical model involving banks and central bank collateral policy, we measure collateral policy on the basis of bank stock returns. To extract the surprise component of each event, we calculate the first principal component of large euro area bank stock returns over a 45-minute intraday window, in line with the literature on monetary policy identification using high-frequency data. We interpret events that triggered positive bank stock price reactions as expansionary. Various diagnostic tests confirm that the series is not contaminated by information effects, exhibits no autocorrelation and is not predicted by financial or macroeconomic stress indicators.

Expansionary collateral policy reduces uncertainty and bank default risk

In line with the underlying theoretical framework, expansionary collateral policy surprises are associated with persistent excess returns on bank stocks. A single-standard deviation collateral policy surprise also reduces the V2X volatility index by around 4%, suggesting a dampening effect on financial market uncertainty. Bank CDS spreads decline by around four basis points on average, while substantially larger effects (exceeding 10 basis points) arise for banks that are less liquid and less capitalised, as well as for banks located in the euro area periphery. The results reveal generally stronger effects in periods of economic stress and before the Eurosystem started to purchase assets at a large scale.

Sovereign bond market effects

Government bond spreads over the risk-free rate narrow significantly — by roughly 10 basis points for periphery sovereigns (Italy, Ireland, Portugal and Spain) compared to only around two basis points for core sovereigns — leading to compression in the core-periphery spread. Sovereign CDS spreads follow a similar pattern. These effects are particularly pronounced for events affecting the collateral treatment of sovereign bonds and are consistent with the heterogeneous transmission to bank CDS spreads.

The transmission mechanism sharply differs from conventional monetary policy

Despite being symmetric by design, collateral policy generates asymmetric effects on bank default risk and the sovereign bond market. This is driven by the interplay between bank heterogeneity and home bias: as riskier, less liquid periphery banks hold more domestic sovereign debt, any reduction in their default risk is disproportionately reflected in periphery bond prices. Unlike conventional monetary policy surprises, collateral policy generates notable excess returns in the banking sector and heterogeneous effects on the sovereign bond market. Taken together, this points to a fundamentally distinct transmission mechanism that works via bank default risk rather than policy rate expectations.

Policy implications

Collateral policy is an effective tool for reducing financial fragmentation, particularly during periods of economic and financial stress. However, its transmission is inherently uneven across the euro area due to home bias in sovereign bond holdings and general banking sector heterogeneity. Advancing the banking union and capital markets union could be key to ensuring a more uniform transmission across member states.

Hüttl, P., G. Ider, M. Kaldorf (2026), Collateral policy surprises, Bundesbank Discussion Paper, No 22/2026.

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