Several central banks accept corporate bonds as collateral for short-term borrowing, especially in financial crises. Relaxing collateral standards is intended to ease money market frictions, but has substantial side effects on bond markets.

Research question: which trade-off does the central bank face and how is collateral policy affected in a crisis?

Banks can use their corporate bond holdings to settle liquidity deficits on money markets. Anticipating this benefit, banks are willing to pay eligibility premia on corporate bonds. We label this the pricing effect. Empirically, the issuers of eligible bonds increase risk-taking and dividend payouts, which we call the borrower effect. Relaxing eligibility standards has a positive impact through the money market channel and a negative impact by subsidizing risk-taking through the bond market channel.

Dynamic capital structure model: eligibility premia distort the trade-off between tax advantages and default costs. Collateralized money market with two segments: private (interbank repos) and public (CB standing facilities). Assumption: cost of cash lenders decline with collateral quality, costs of cash borrowers decline with amount of available collateral.

The model is calibrated to Euro area before the financial crisis of 2008 and used as laboratory for policy experiments.

Leverage and spread distributions slightly shift to the right. Shift more pronounced in the case of loose collateral standards. Aggregate collateral drops to 73% (94%) in case of tight (loose) policy, borrowing costs increase by 1% (0.2%).

Central bank crowds out almost the entire private money market segment and takes on significant counterparty risk.

Increasing available collateral by relaxing eligibility criteria is very effective for interbank shocks, without inducing excessive risk-taking. In case of fundamental risk shocks, adverse effects via the bond market channel are large. The total effect can be determined using the welfare relevant cost terms. Depending on structure of central bank, welfare depends on how much counterparty risk the central bank is willing to take.