

The shadow bank lending in the eurozone



Raoul Ruparel is the Chief Economist at Open Europe

The actions of central banks are often, even at the best of times, far from clear and explicit - nowhere is this truer than in the eurozone, under the European Central Bank (ECB). We covered the risk of the standard ECB liquidity provision and its bond buying programme in our recent paper *'A house built on sand'*. However, there is an even more opaque and less documented lending tool within the eurozone - the Emergency Liquidity Assistance (ELA). Interest in the ELA has kicked off again, with the announcement by Greek Central Bank Governor George Provopoulos that it was activated in Greece during August.² Not only does this mark another worrying turn for the banking sector during this crisis, but could also signify a further substantial transfer of risk away from the private sector towards taxpayer backed institutions.

An ELA refresher

The ELA is the last call for banks which have run out of suitable collateral to use for the standard ECB lending operations. Unlike nearly all other central banking operations the ELA is enacted mostly at the discretion of the National Central Banks (NCBs), rather than the ECB, although it does require initial approval from the ECB and implicit acceptance (the ECB governing council has the ability to vote to terminate any ELA operations if it so wished). As such, any risks taken on through the ELA are the sole responsibility of the NCB, backed up by the state, not the eurozone (at least in theory, more on this later). The ELA is designed to provide temporary assistance to illiquid but solvent institutions, according to the ECB, unfortunately this is also rarely the truth.³

Where else has the ELA been implemented?

During the financial crisis it was put to use by both Belgium and Germany to tide troubled lenders over in the lead up to a break-up or restructuring (Fortis and Hypo Real Estate respectively).⁴ In these cases, the ELA was fortunately temporary, but only because it was already clear to all that the banks in question were completely insolvent and, as such, restructuring plans had already been put into motion. Worryingly though, the ELA has been extensively used in Ireland since October 2010. It currently accounts for €57bn in lending to Irish banks, and topped €70bn back in February - clearly it is neither temporary nor insignificant.

In recent weeks it has been revealed that Greek banks have begun tapping the ELA and, although the extent is still unknown, this is undoubtedly a troubling development. Evidence from Ireland suggests that, without a credible restructuring or consolidation plan for the banks involved, these lenders could quickly become addicted to the so-called emergency lending.⁵

What do we know about the processes of the ELA?

Unfortunately, not much. The biggest concern with the ELA is its opacity and secrecy, in fact the central banks don't even have to announce its existence (although they usually do for fear of an uncontrolled leak creating market panic). The details on the lending are sparse, with the interest and collateral taken on remaining secret.

The lending rates should in theory be set at painful levels, to penalise banks for entering this 'last chance saloon' and to push them into alternative funding sources as soon as possible. Clearly, this has not

been the case in Ireland - it seems highly unlikely that the stricken Irish banks could have afforded to continually role over tens of billions in short term lending at high rates. Given the complete lack of alternatives for Greek banks (they've been reliant on ECB lending for as long as anyone) it's probable the Greek Central Bank will limit the rate as much as possible and help facilitate another huge transfer of risk from the private sector to the public sector at minimal cost.⁶ Besides, the reluctance to impose costs on the banking sector has already been demonstrated across Europe with the staunch opposition to a debt restructuring and the heavily incentivised private sector involvement in the second Greek bailout.

The collateral taken on paints an even more depressing picture. As mentioned, the only reason to enact this program is if the banking sector has run out of eligible collateral for the ECB (whose standards are, let's be honest, not exactly sky high these days - see reversals on accepting lower rated government bonds). Likely culprits include: government guaranteed bank bonds, promissory notes and low quality asset backed securities, to which unknown haircuts are applied and unknown valuations are given, often at the central bank's discretion since no effective market exists for many of these instruments (a problematic paradox as almost by definition that is why they are being used for the ELA).

A quick glance back at Ireland gives us an interesting snapshot of this problem, in that Irish banks were issuing themselves state backed bank bonds and then using these as collateral for ELA (and if possible ECB) loans - insolvent banks backed by an insolvent state creating more debt to gain liquidity of unknown levels at unknown rates. This can in no way be healthy for the long term stability of the Irish and possibly European economy.

Doesn't this amount to money printing?

Not quite (for the most part). In reality, it's not clear where the money for the ELA actually comes from, a point which has been subject to much debate (well as much as there can be surrounding a fairly secretive and technical aspect of financial markets). Since the ELA is the NCBs responsibility, the money should come from the NCBs balance sheet. This could involve using existing financial assets or taking on, or even creating, more short term deposits.⁷ There is also the fact that there is some collateral given in exchange, but its value may turn out to be far lower than estimated and it is still essentially monetising otherwise unsellable assets. However, you can, obviously, never conclusively prove that the monetary base has increased further than it would in another state of the world.

That said, evidence suggests that it is difficult for the ECB to fully account for these purchases through sterilisation (removing liquidity from European financial markets to offset any increase from the ELA) and the low quality of the collateral means the programme stands apart from the ECB's pledge of unlimited liquidity. Therefore, although it is not directly money creation or quantitative easing, there could be close similarities depending on the actual structure of the ELA.

Whose risk is it anyway?

As mentioned above, the ELA normally comes with an explicit state guarantee, meaning the state will cover any losses on the ELA loans,

a likely scenario given that the collateral is usually highly illiquid.⁸ The issue here is that, in cases such as Ireland and Greece, it is very unlikely that the State would be able to afford to cover any ELA losses, especially if they reach into the tens of billions. Both Greece and Ireland have strict deficit targets to meet, failure to do so would likely be poorly regarded by financial markets but also the ECB and IMF and my result in difficulties in receiving tranches of bailout aid. In any case, since these countries are already reliant on eurozone and ECB funding (via their banking sector and the SMP) it seems obvious that the ultimate risk would be transferred to other eurozone member states or the eurosystem. This could either be through increased ECB bond buying, requests for additional financial aid or simply using current aid to cover losses, all highly undesirable outcomes for eurozone taxpayers. This is not to mention the uncertainty surrounding the process of accounting for any losses, which would itself have knock on effects in jittery financial markets.

It's a sad, if not slightly ironic state of affairs. The eurozone governments created the risk with too much debt (in many cases) which was bought up by banks and helped facilitate the sovereign-debt and banking crisis in Europe, the banks then shifted this debt to the ECB through its liquidity provision, while the ECB shifted the worst of this debt back to the NCBs and states with the ELA, but given the continuing bailout programme propping up these states the risk is transferred back across the eurozone. Obviously, a simplified chain of events but it helps emphasise the continual recycling of risk and debt around the eurozone, as opposed to finding a long term solution – a process of which the ELA is becoming an increasingly integral part.

Is this just a transfer of risk then?

It is undoubtedly another stage in the transfer of risk away from the private banking sector towards taxpayers backed institutions and possible even across national boundaries, but it is also more than that. It has been claimed that the ELA simply replaces other costs, for example by stopping the collapse of the banking sector and preventing another bank bailout or by making sure that these banks can still purchase government debt, helping to keep governments afloat. That is true to some extent but in doing so it also detracts from the necessary steps which need to be taken to ensure the long term health of the banking sector and the eurozone economy, helping to cement and restore the failed practices which placed the banks in their current position in the first place.

Many of these banks need to deleverage and recapitalise significantly and in many cases there needs to be a consolidation of the banking sector, especially in Greece and Ireland, and some parts of the banks need to be wound down. Propping them up with cheap liquidity may stop some short term pain but will not help in the long term and could be incredibly costly given the massive uncertainty which these banks are exposed to in the eurozone crisis. Failures elsewhere, such as in the second Greek bailout deal, the Italian austerity package or the ratification of the EFSF in Parliaments across Europe could have knock on effects which would threaten fragile banking sectors – something we are already seeing with the recent punishment of European bank shares.

This argument also forgets that it has been made explicitly clear by the ECB that the ELA should only be used for temporary liquidity problems and should not be extended to insolvent institutions – how Irish and Greek banks, backed up by insolvent states, satisfy this criteria remains an unanswered question.⁹

Indicative of the eurozone crisis

The ELA is, on its own, still only a small part of the eurozone crisis, although the worse things get, the bigger it is likely to become in both Greece and Ireland. More importantly, it throws up another opaque and technical barrier to reform in the eurozone and any attempts to fully understand the risk involved in the crisis – indicative of the ECB's and eurozone leader's actions throughout the crisis. At best it is a stop gap measure, which has its uses when providing emergency liquidity during the transition of a financial institution, but has been abused to suit the needs of the crisis, deflecting from more effective and lasting measures. Its on-going usage and expansion to Greece highlights the massive failure of the bailout policy and of throwing increasing liquidity at what is, and debatably always has been, a solvency issue.

Mechanisms such as the ELA and the bailouts should be wound down as soon as possible and replaced by a widespread recapitalisation of the banking sector, a debt restructuring of insolvent states (Greece, Portugal and probably Ireland) and a series of reforms aimed at restoring competitiveness and growth in these newly burden free economies. These three factors are almost impossible to avoid if the eurozone has any chance of long term survival, better to get on with them than to continue to recycle and shift debt around the eurozone in ever more secretive ways. ■

1. Open Europe, 'A house built on sand? The ECB and the hidden cost of saving the euro', 6 June 2011: <http://www.openeurope.org.uk/research/ECBandtheeuro.pdf>

2. Cited in Reuters, 'Greek Central bank provided emergency funding to banks', 3 September 2011: <http://www.reuters.com/article/2011/09/03/greece-cenbank-idUSL5E7K314K20110903>

3. For an excellent discussion of the issue see: Citigroup Global Economics View, 'ELA: An Emperor without clothes', 21 January 2011, available at: <http://www.nber.org/~wbuiter/ela.pdf>

4. Cited in Irish Independent, 'We are not the first to use ELA to dig out lenders', 10 February 2011: <http://www.independent.ie/business/irish/we-are-not-first-to-use-emergency-liquidity-assistance-to-dig-out-lenders-2533374.html>

5. Morgan Stanley, 'Emergency Liquidity Assistance in the Euro Area', November 2010.

6. Cited in FT Alphaville, 'Ireland's secret liquidity is unbelievably cheap', 8 February 2011: <http://ftalphaville.ft.com/blog/2011/02/08/482281/irelands-secret-liquidity-is-unbelievably-cheap/>

7. Cited in FT Alphaville, 'The mechanics of Irish euro-printing', 18 January 2011: <http://ftalphaville.ft.com/blog/2011/01/18/461881/the-mechanics-of-irish-euro-printing/>

8. There is also the side issue here that under a state guarantee, the ELA should be added to the gross government debt calculations. Since it should even out on the NCB balance sheet it may not have a massive impact but should still be taken account of to make the risks clear.

9. ECB speeches, 'Remarks by T Padoa-Schioppa, Member of the Executive Board EUROPEAN CENTRAL BANK', Jakarta, 7 July 2003, available at: <http://www.ecb.int/press/key/date/2003/html/sp030707.en.html>