

## The European Central Bank – the changing role of the ECB during the debt crisis

### Introduction

The ECB has played an active role in the debt crisis that has submerged the Eurozone since early in 2010. Together with the European Commission (EC) and the IMF it is one of the members of the troika that has been responsible for defining policy response as events have unfolded over the last year and a half.

This note looks at how the ECB's role has evolved and, more recently, how it has tried to take a more independent line. From a charitable point of view, this response can be regarded as the ECB wanting to return to a normalisation of its monetary policy but the truth is somewhat different. The reality is that, with the periphery countries it is trying to provide assistance to, the ECB has become so embroiled in the crisis that its own assets and capital have been severely weakened. The importance of this should not be lost on investors because it has, and will, limit the ability of the ECB to help shore up the periphery countries and, in the event of a default, the bank itself may need recapitalisation from the 17 Eurozone central banks.

### The ECB's central role in the ongoing debt crisis

#### 1. Funding the commercial banks

One of the defining characteristics of the 2007-8 financial crisis was how the nature of commercial bank funding changed before and after the fall of AIG and Lehman's. The use of derivative products such as collateralised debt obligations (CDO) was one of the main reasons why the crisis was so severe. This new technology of debt allowed banks to increase gearing and rely less on the traditional funding route of deposit taking.

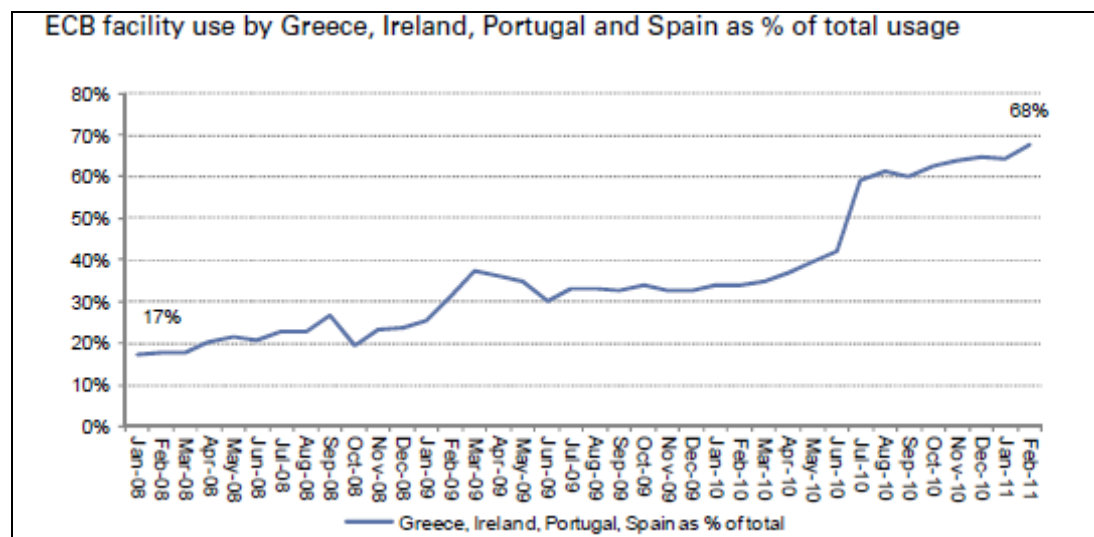
Following the collapse in 2008, the fear that financial institutions would be exposed to further risks through bad loans led to a significant drop in inter-bank funding and confidence. This is the hallmark of a credit crunch as banks hoarded cash to preserve capital with the result that many banks found it difficult to get the necessary funding for day to day operations. In such circumstances, one of the important roles of the ECB is to provide short term funding through its repo operations and Emergency Liquidity Assistance (ELA) facility.

Since the onset of the sovereign debt crisis last year in the Eurozone, the commercial banks have once again become dependent on the ECB for funding. This time it is the fear of sovereign default rather than commercial banks that has led to the lack of inter-bank funding. As can be seen from the table below, the Eurozone commercial banks hold large quantities of Greek, Irish and Portuguese debt and it is the fear that this might be worth much less than is recorded in the banks' accounts that has contributed to a lack of trust within the banking sector.

<b>Greek Sovereign Debt</b>			<b>Irish Sovereign debt</b>			<b>Portuguese Sovereign Debt</b>		
	€bn			€bn			€bn	
1	NBG	19.4	1	Allied Irish Bank	13.4	1	CGdD	6.8
2	ABG	10.0	2	HRE	10.3	2	BPI	4.2
3	Piraeus Bank	8.4	3	Bank of Ireland	8.3	3	HRE	3.7
4	HRE	7.9	4	Landesbank BW	0.6	4	Santander	2.8
5	EFG Eurobank	7.5	5	KBC	0.6	5	Landesbank BW	2.2
6	GPSB	5.4	6	Barclays	0.5	6	Dexia	1.9
7	BNP Paribas	5.0	7	BPI	0.4	7	BNP Paribas	1.9
8	Alpha Bank	4.6	8	Bank of Cyprus	0.4	8	ING Bank	1.8
9	Dexia	3.5	9	BNP Paribas	0.4	9	WestLB	1.7
10	Commerzbank	3.0	10	BPCE	0.3	10	BES	1.5
...	Other	26.5	...	Other	4.5	...	Other	10.7
<b>Total</b>		<b>101.1</b>	<b>Total</b>		<b>39.7</b>	<b>Total</b>		<b>39.3</b>
o/w Greece & Cyprus (€bn) 60.2			o/w Ireland (€bn) 21.8			o/w Portugal (€bn) 13.4		
o/w Greece (%) 60%			o/w Ireland (%) 55%			o/w Portugal (%) 34%		

(1) Figures compiled for Bank of Ireland and Allied Irish Bank include exposure to bonds issued by NAMA.  
(2) Sample of banks selected for this analysis includes European banks under GS coverage as well as institutions covered by CEBS stress test.

Every Monday, the ECB calls for tenders for its 7-day repo agreements at its current rate of 1.25% minimum. Last week the ECB announced that it accepted €116.1bn in bids from 241 banks in the Eurozone, compared to 235 the week before. This represents about 1/3<sup>rd</sup> of the banks in the union and reflects how many institutions are considered too risky as counterparties for unsecured short term cash lines. The chart below shows how much ECB funding from its facility has increased since the financial crisis.



It should be noted that huge quantities of periphery debt are held outside the periphery as well, adding to the uncertainty and risks. The table below shows that nearly 41% of Greek, Irish and Portuguese debt is held by German, French, Benelux and UK banks. It explains the self interest of Germany and France, as the leading members of the Eurozone, to prevent a default or partial restructuring but also adds to the malfunctioning of the liquidity system within the Eurozone.

Greek Sovereign Debt			Irish Sovereign debt			Portuguese Sovereign Debt					
	€bn	%		€bn	%		€bn	%			
1	Greece & Cyprus	60.2	60%	1	Ireland	21.8	55%	1	Portugal	13.4	34%
2	Germany	18.7	19%	2	Germany	13.0	33%	2	Germany	11.4	29%
3	France	9.6	9%	3	Benelux	1.0	2%	3	Benelux	4.4	11%
4	Benelux	6.6	7%	4	UK	1.0	2%	4	Spain	3.8	10%
5	Italy	1.7	2%	5	France	1.0	2%	5	France	3.4	9%
6	UK	1.4	1%	6	Portugal	0.8	2%	6	UK	1.7	4%
7	Portugal	1.3	1%	7	Greece & Cyprus	0.4	1%	7	Italy	0.3	1%
8	Austria	0.7	1%	8	Italy	0.3	1%	8	Ireland	0.2	1%
9	Spain	0.5	0%	9	Nordic	0.3	1%	9	CEE and other	0.2	1%
10	Nordic	0.2	0%	10	Austria	0.1	0%	10	Austria	0.2	0%
11	CEE and other	0.2	0%	11	Spain	0.1	0%	11	Nordic	0.1	0%
12	Ireland	0.0	0%	12	CEE and other	0.0	0%	12	Greece & Cyprus	0.0	0%
Total	101.1	--	Total	39.7	--	Total	39.3	--			
o/w GIP	61.5	61%	o/w GIP	23.0	58%	o/w GIP	13.7	35%			

Note: Sample of banks selected for this analysis includes European banks under GS coverage as well as institutions covered by CERS stress test.

## 2. The purchase of periphery government bonds in the secondary bond market

As the sovereign debt crisis deteriorated last year the pressure grew on the ECB to take a more activist role. One of the problems facing the sovereign states in trying to reduce their deficits and debt to GDP ratios is that the yield on their respective government bonds can make it prohibitively expensive to raise funds in the open market to provide the necessary liquidity for funding. The yields reflect market forces but the EU authorities have been critical of speculation creating a false market.

To assist the periphery countries, the ECB was empowered with the ability to buy bonds in the secondary market. The crucial difference to the UK and US QE programmes was that the bond purchases would be sterilised (i.e. matched by a corresponding sale) so that it was not increasing the size of the overall monetary base. The decision to allow the ECB to do this was

controversial and came after strenuous denials, including from the President of the ECB himself, M Trichet. The volte face reflected the threat that the periphery countries would be locked out of the market and therefore unable to finance themselves, so triggering a default.

In the event the bond purchase programme has been an unqualified failure. It may have temporarily stabilised bond markets and enabled the periphery states to raise funds at slightly lower interest rates on occasions, but ultimately it has not prevented three countries needing bailouts and Greece being on the brink of default. The ECB has bought huge quantities of low quality periphery bonds, including an estimated €45bn of Greek bonds that has greatly weakened its own balance sheet. In addition, it has accepted Greek and other periphery country bonds as collateral against loans granted by the ECB. As at the end of March, the ECB's loans to the Greek banking sector stood at €90.4bn. This may explain why the bank has not bought any further periphery bonds in the open market in the last eight weeks, despite the crisis being at its worse level for over a year and Greek and other periphery yields widening to record highs.

### **The ECB threatens to cut off funding to Greece in the event of default**

Last week the ECB said it would not accept Greek bonds as collateral if the country defaulted. This included a soft restructuring such as the much mooted 're-profiling' that would extend the maturity of the bonds. If the ECB carried out this threat it would cause several Greek banks to go bust and precipitate a major banking and financial crisis in Europe and beyond. So why should the ECB take such a contrary stance?

The reason for its hard line stance is that the ECB cannot afford to allow its balance sheet to weaken anymore. It desperately wants to distance itself from the debt crisis and normalise monetary policy rather than being used as an emergency lifeboat for the sinking periphery countries. It recognises that the sinking peripheries are submerging the ECB itself and there has been increased speculation in recent weeks that the ECB itself may be vulnerable. The act of brinkmanship by the ECB is a warning to the other members of the troika that the Eurozone cannot afford a default, however 'soft' the default or restructuring would be. In effect, it is vetoing such an action and forcing the EC and IMF to put their heads together with Greece and reach a workable alternative that would not risk undermining confidence in the banking system.

In terms of the ECB's own vulnerability to a default, the independent research firm Breaking Views has stress tested the bank on the assumption that the debt ratios are reduced to 90% of GDP via a restructuring. On this basis, the ECB would incur a loss of €12.2bn on its Greek bonds and €3.2bn on the combined holdings of Irish and Portuguese bonds. The total of €15.8bn loss is large but compares to capital of €81.2bn and it would have gearing of 29x compared to 20x in early 2007.

However, as M Trichet, the President of the ECB, and his colleagues know it is the contagion to the euro banking system that would cause the pose the real threat. Eurozone central banks have lent €242bn to Greek, Irish and Portuguese banks and it would only take a loss of 27% of these loans to wipe out the euro banking sector's capital when added to the direct government bond holdings. The ECB may be holding a gun to the head of the EC and IMF but it is doing so for a good reason.

### **Summary**

The ECB has stood by the periphery countries throughout the Eurozone crisis while sacrificing its own reputation, credibility and principles of sound money. It started with the decision to waive its longstanding requirement that it would only accept investment grade sovereign debt as collateral when Greece's credit rating collapsed over a year ago. It has continued since with the u-turn to buy bonds directly in the open market and its role as emergency funding provider as confidence between the euro banks has collapsed. The ECB is torn between preserving its own integrity and preventing its own balance sheet weakening further and containing the debt crisis which shows no sign of abating.

The ECB is correct to take a hard line stance now because a default would have disastrous financial consequences on a global scale. Yet it has only its own folly to blame for having

arrived in this unenviable situation. Although it has managed the sovereign debt crisis badly, the real fault was in allowing the interest rate spreads on periphery state government bonds to fall so much in the period up to 2007. Despite budget deficits and debt levels that greatly exceeded allowable limits, Greece and other weaker nations were able to borrow at similar rates to Germany in the open market. Investors and rating agencies were also to blame, but the ECB continued to accept periphery debt as collateral and then changed the rules so it could continue to accept it when the rating agencies belatedly did downgrade.

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