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DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Non-Standard Policy Measures - A First Assessment

NOTE

Abstract

In this note I discuss the effect of the ECB's new long-term refinancing operations (LTROs) on bank lending to the real economy and on sovereign debt markets. I also discuss the implication of its change in collateral policy.

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EXECUTIVE SUMMARY

- On 8 December 2011 the Governing Council of the ECB unveiled two new policy measures: two very long term full-allotment refinancing operations and a relaxation of collateral requirements.
- Bank lending to the private sector had been in marked decline and the new refinancing measures did not lead to a rebound. They did, perhaps however, slow the rate of deterioration.
- The new measures were an immediate success in calming financial markets. Yields on euro area periphery sovereign debt declined markedly and global equity markets revived.
- The refinancing operations were an indirect way of purchasing sovereign debt in the new issuance market, something the Eurosystem is forbidden to do directly. The likely intent was for periphery country banks to borrow long term at subsidised interest rates and then, through their own volition or the persuasion of their government, to use at least some of this money to purchase sovereign debt.
- The short-run success of the measure in reassuring financial market participants was probably due to its signal value. This new measure announced that there had indeed been a changing of the guard at the ECB and that the new management was prepared to do what it takes – within the confines of the Treaty – to calm sovereign debt markets and to prevent sovereign debt default or a collapse of systemically significant financial institutions.
- While market participants became more sanguine, the rise in balances at the ECB's deposit facility suggests that banks are parking much of their increased liquidity at the central bank. If lending to the real economy is going to revive, the ECB must continue to demonstrate that it is playing its role in acting as lender of last resort and banks need to strengthen their balance sheets by raising more capital.
- The change in collateral standards was an initiative of more doubtful quality. Allowing individual central banks to take a more risky approach to lending on their own accounts raises the spectre of bankrupt central banks and sovereigns that cannot recapitalise them. As national banks have no other lender of last resort euro area policy makers might have the disagreeable choice of letting the rest of the system recapitalise a failed national central bank or having a national banking system collapse.

1. INTRODUCTION

On 8 December 2011 the Governing Council of the European Central Bank (ECB) announced two unprecedented policy measures to support bank lending and liquidity in the euro area money market. The key feature of the first measure announced was two longer-term fixed-rate and full-allotment refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year. The interest rates were set at the average rate of the main refinancing operations over the life of the respective operation. The allotment dates were 21 December 2011 and 29 February 2012. The second measure announced was an increase in the set of eligible collateral, achieved by reducing the rating threshold for some asset-backed securities and by temporarily allowing national central banks to accept performing bank loans satisfying specific eligibility criteria as collateral.

2. THE NEW LTROS

In this section I discuss the first new measure: the longer-term LTROs. A total of 523 banks bid for EUR 489.2 billion in the first (21 December 2011) longer-term LTRO, while 800 banks bid for EUR 529.5 billion in the second (29 February LTRO). Given that some previous shorter-term LTROs had matured, the total increase in liquidity from LTROs after the second operation was EUR 522.6 billion.

2.1. The New LTROs and Bank Lending to the Real Economy

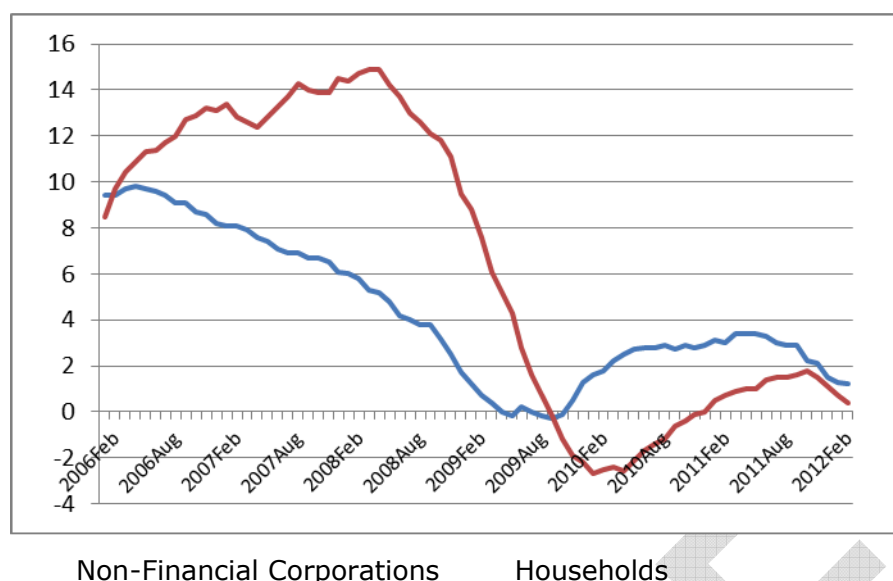
Although little time has passed since the announcement or carrying out of this non-standard measure, it is interesting to evaluate the extent to which the ECB has advanced or might be expected to advance its objectives. To do this, one must first start by asking what the ECB's objectives were. The ECB is emphatic that its primary goal was to increase bank lending. In a 9 February 2012 press conference ECB President Mario Draghi stated, "*... as I have said repeatedly, our primary interest is in lending to the real economy.*" While, it is likely that the long-term lending to euro area banks at a subsidised rate was more importantly intended to be a roundabout way of acting as a lender of last resort to euro area sovereigns and thus calming financial markets, I first consider how the LTROs may have influenced the retail market for bank loans.

It is not possible to quantify the impact of the ECB's measures on lending to the real economy. Not enough time has passed for much data to be available and even in the longer run this is a near impossible exercise because of the difficulties in specifying the counterfactual in such an unconventional economic scenario. Consequently I will discuss the conditions in the retail lending market and suggest how the policy measures might have affected them or how they might be expected to affect them in the future.

2.1.1. Conditions in the retail market for bank loans before the new measures

Prior to the announcement of the new LTROs, it was clear that the growth in bank lending to the real economy was in marked decline. As shown in Figure 1, the annual growth in Monetary Financial Institution's (MFIs) loans to households had been falling since September 2011 and loans to non-financial corporations had been in decline since October 2011.

Figure 1. Annual Growth in MFI Lending to Non-Financial Corporations and Households



Source: ECB, data is seasonally adjusted.

Not only had the growth in the volume of loans fallen, the terms and conditions had become harsher as well. The Euro Area Bank Lending Survey of January 2012 suggests that outside of Germany, euro area banks had significantly tightened their credit standards and raised interest rates on loans to non-financial firms and households in 2011 Q4.

Small and medium size enterprises (SMEs) account for two-thirds of all corporate employment in the EU and are particularly dependent on bank funding.¹ According to the SME's Access to Finance Survey of December 2011, 87 percent of these firms that had received a loan in the past two years had obtained it from a bank. These firms listed access to finance as their second most pressing concern (after finding customers) and 27 percent said that banks had become less willing to loan over the past six months compared to only 13 percent that said that banks had become more willing.

2.1.2. Conditions in the retail market for bank loans after the new measures

It is clear that the announcement of the new LTROs did not suddenly cause bank lending to rebound, but there are small signs that after the announcement of the new measures the deterioration in the bank lending market became less pronounced. Annual growth in MFI's loans to non-financial corporations has been declining steadily since November 2011, but the annual growth in MFI's loans to households, which had fallen sharply from 2.1 percent in November 2011 to 1.5 percent in December 2011, declined a more moderate 0.2 and 0.1 percentage points in January and February 2012, respectively. Looking ahead, the *Euro Area Bank Lending Survey* of January 2012 suggests that euro area Banks expect a further tightening of credit in 2012 Q1, but at a slower rate.

One reason for a levelling off of the decline in banking lending conditions might be the new LTROs provision of low-cost liquidity. There is some limited evidence that the ECB's unconventional policies since the beginning of the financial crises have supported bank lending through an increased liquidity channel. Lenza, et al (2010), while acknowledging the difficulties inherent in such a study, estimate that previous non-standard policies should have had a positive impact on loans for house purchases and consumer loans. The overall

¹ *SME's Access to Finance Survey*, December 2011, fn. 3, p. 3.

impact on short-term loans to non-financial firms is less clear as an expected lagged improvement follows an estimated immediate decline in lending.

It should be mentioned in this context that the design of the LTROs was rather clever. Holding two auctions gave banks that abstained from the first round out of fears of a stigma a second chance to borrow in the second. Many small banks that lend to SMEs joined the second round, when the details of collateral eligibility of individual bank loans had been worked out.

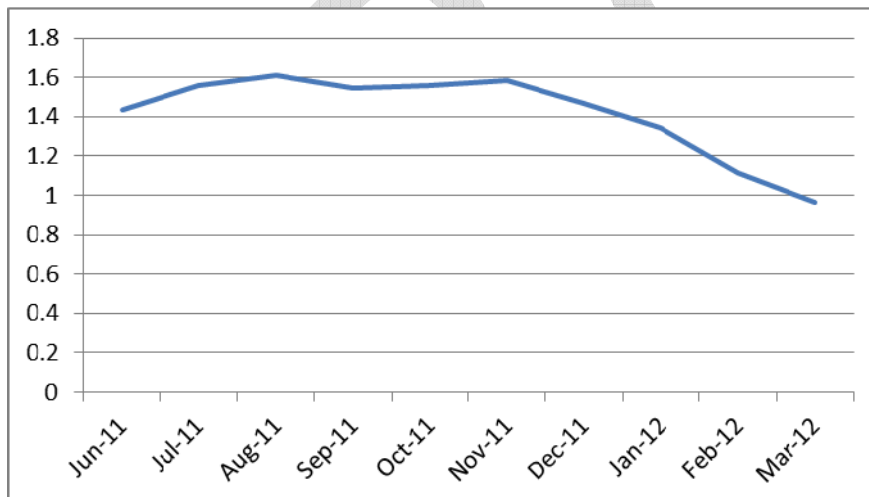
2.2. The Effect of the LTROS on Euro Area Financial Markets

Although the immediate impact of the new LTROs on bank lending seems to be muted, these operations appear to have at least temporarily stopped a fast deterioration in financial conditions in the euro area and in particular in bank funding markets and have also led to large increases in asset prices and some improvement in investor sentiment. If financial conditions continue to moderate, conditions in retail bank lending markets should as well.

2.2.1. The LTROs calmed financial markets

A number of indicators suggest that tensions in financial markets have eased since the announcement of the new LTROs. As seen in Figure 2, the three-month Euribor rate (a reference rate based on the average rate that banks in the euro area make unsecured loans to each other) had been declining since October 2011, but the rate of decline quickened after early December 2011. As of 23 March 2012 the rate had declined to 0.808 percent.

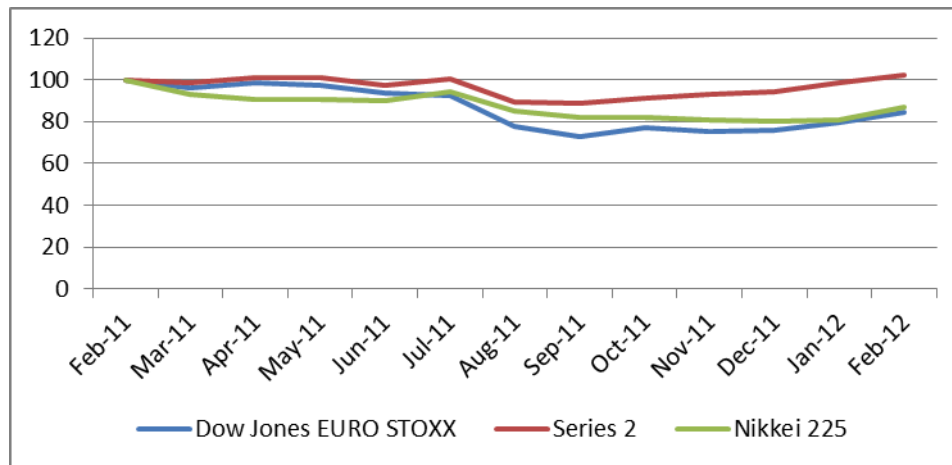
Figure 2. Three-Month Euribor



Source: Euribor-rates.eu, first day of each month

Asset prices have risen substantially. As seen in Figure 3, the monthly average Dow Jones EURO STOXX (broad) index rose by 12.8 percent between November 2011 and February 2012. The United States Standards & Poor's 500 index rose by 10.3 percent and the Japanese Nikkei 225 rose by 8.7 percent.

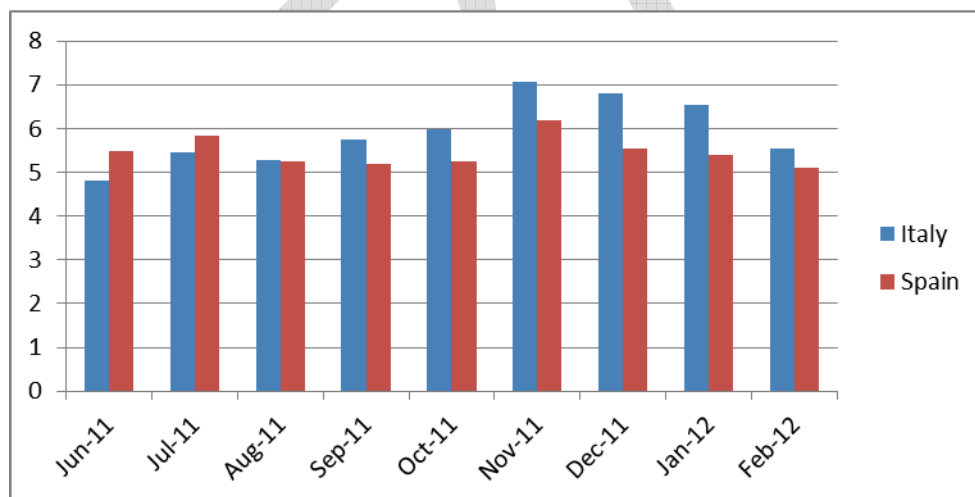
Figure 3. Stock Market Indices (Monthly Averages, Feb 2011 = 100)



Source: ECB

As seen in Figure 4, yields in the secondary markets for Italian and Spanish sovereign debt have come down considerably since their highs in November 2011. On 27 March 2012 the yields on 10-year Italian and Spanish debt had fallen to 5.0082 percent and 5.3116 percent, respectively.

Figure 4. Ten-Year Sovereign Debt Yields (Secondary Markets)



Source: ECB, period averages

On 27 Mar 2012 the Italian Treasury sold EUR 2.8 billion two-year bonds and the average yield was 2.35 percent, down from 3.01 percent a month earlier. On 1 Mar 2012 the Spanish Treasury sold EUR 4.5 billion bonds and the average yield on two-year debt was 2.07 percent.

2.2.2. The LTROs and the sovereign debt crisis

Both Spain and Italy's fiscal situations are likely to be sustainable if their financing costs are low; however, if they face sufficiently high interest rates they will default. This leads to two possible equilibria based on self-fulfilling expectations. The first is a socially beneficial one where market participants believe that Spain and Italy will repay their debt, interest rates on Spanish and Italian sovereign debt remain low and, consequently, Spain and Italy remain solvent. The second is a fear-driven outcome where market participants believe it is likely that Spain and Italy will default and interest rates on Spanish and Italian debt climb sharply; Spain and Italy are then forced into default.

In a scenario where there are multiple equilibria in financial markets it is the proper role of central banks to ensure that the socially beneficial one prevails. They should be willing to act as lender of last resort to an illiquid but solvent bank and to avert a fear-driven run on sovereign debt that is not warranted by the fundamentals. If a country has its own currency then its central bank can be given the ability to stand ready to purchase new issuance of home-currency denominated sovereign debt that carries an excessively high yield. Unfortunately, in the euro area the Treaty forbids the Eurosystem from purchasing Member States' sovereign debt in the primary issuer market.

Endangered euro area sovereigns have other lenders of last resort: the European Financial Stability Mechanism (EFSM), the European Financial Stability Facility (EFSF) and its successor the European Stability Mechanism (ESM), and the International Monetary Fund. However, the size of the available funds is small relative to the periphery sovereigns funding requirements: see Buiter and Rahbari (2012) for a detailed analysis of this. Consequently, the ECB has been forced to intervene.

As the Eurosystem cannot directly purchase newly issued sovereign debt it has been forced to either purchase sovereign debt in the secondary market or to find a mechanism that allows the indirect purchase of newly issued debt. The first approach was attempted under the Securities Market Programme. It is inefficient, however, to cap the yield on the entire outstanding debt stock, which effectively requires an offer to purchase all outstanding sovereign debt at above-market prices, just to keep the yield on newly issued sovereign debt within bounds. The LTROs are an example of the second approach. The idea is that the ECB offers to lend money to banks at a subsidised rate and its offer is taken up by banks in the periphery countries which then, either through carry trade or the suasion of their governments, purchase their countries' newly issued sovereign debt.

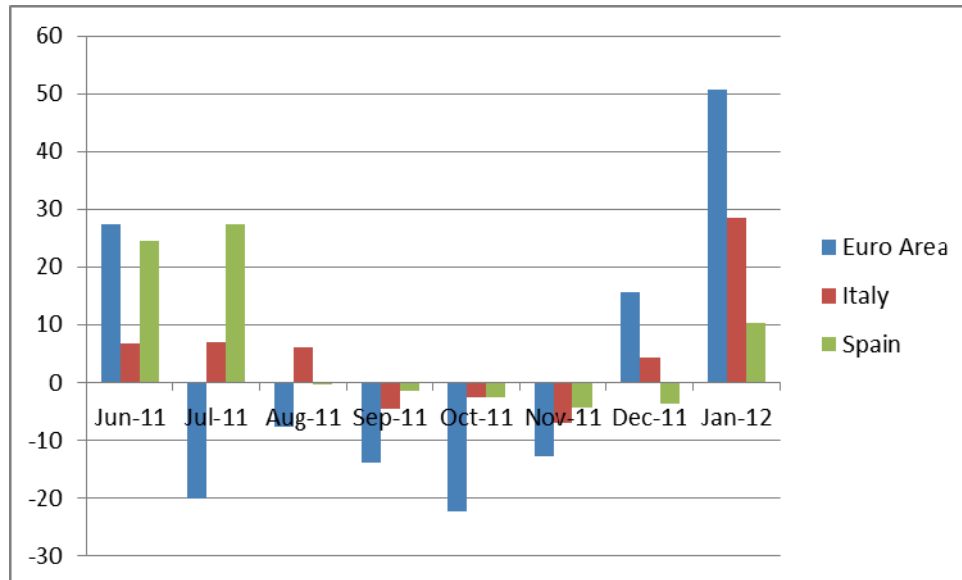
The ECB, with its characteristic opacity, does not release the details of its transactions or even a country-by-country breakdown of borrowing; hence we are unsure of exactly which banks borrowed how much in the two new LTROs.² Nevertheless there are indications that a large part of the funds went to periphery sovereigns. The Banca d'Italia stated that Italian banks took up EUR 139 billion of the EUR 529.5 billion that was borrowed in the second LTRO. Analysts at UBS estimate that Italian and Spanish banks took up a total of EUR 260 billion and EUR 250 billion, respectively, in the two LTROs and other Eurosystem liquidity offerings.³

² Mario Draghi did say at the 8 March press conference that, "Of these [800 banks that borrowed in the second new LTRO], 460 are German banks, even though I should hasten to add the overall amount borrowed by German banks is lower, or much lower, than the overall amount borrowed by other countries."

³ Cited in Milne, Richard and Mary Watkins, "By Piling on Funds to Save Banks, the Monetary Authorities may Initiate a Renewal of the Euro Crisis," *Financial Times*, 27 Mar 2012.

Available data up through January 2012, shown in Figure 5, suggests that at the first LTRO was effective at increasing bank holding of Spanish and Italian government debt.

Figure 5. MFI's (excluding the Eurosystem) Purchases of General Government Debt (EUR billions)



Source: ECB

Unfortunately, there are some problems associated with the LTROs. First, they are a less efficient way of acting as lender of last resort than intervening in primary sovereign debt markets would be. Only some of the money that is borrowed will be used to purchase fiscally endangered sovereigns' debt. Second, since the borrowing is open to all of the ECB's counterparties, this subsidised lending that is ultimately paid for by euro area tax payers is partially to the benefit of financial institutions outside the euro area. Several UK banks, for example, have helped themselves to funding through their euro area subsidiaries. Third, providing banks with large amounts of cheap liquidity may have the undesirable side effect of lessening their incentives to improve their balance sheets.

2.2.3. The LTROs and the wholesale market for bank funding

The on-going euro area sovereign debt crisis has weakened banks' balance sheets, making banks riskier counterparties and it has lowered the value of the collateral that they use to secure additional funding. As the effect on individual bank balance sheets is imperfectly observable, adverse selection problems have magnified. The improved outlook for the sovereign debt crisis can be expected to improve conditions in the interbank lending market. Consistent with this, according to the Euro Area Bank Lending Survey of Jan 2012, banks expect some improvement in wholesale market funding in 2012 Q1. As banks' assessment of their liquidity positions improves, so should their attitudes toward lending.

It is a beneficial side effect of the LTROs that additional liquidity is provided to the banking system, perhaps directly facilitating lending to the real economy. But, the real benefit is the normalisation of the wholesale funding market through the improvement of banks' balance sheets and the lessening of adverse selection problems. It is primarily through this less direct channel that bank lending to the real economy can be expected to be more robust than it otherwise would have been.

2.2.4. Why did the LTROs have such an impact?

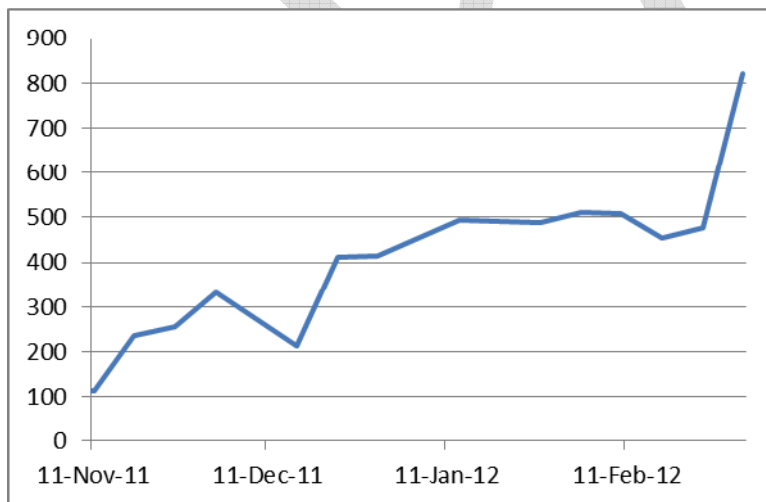
The announcement of the new and unconventional measures was an important signal. Announced on 8 December, the day before the European Council meeting where Member States agreed on the outlines of the fiscal compact, it signalled to the market that there had indeed been a regime change at the ECB; that the new management was willing to be quite creative, within the constraints of its legal framework, to support periphery sovereigns. While saying that the LTROs were motivated by a desire to increase funding to the real economy, Mario Draghi has also emphasised their role in calming markets. He expressed his pleasure at the success of the operations in this regard, saying:

"The risk environment has improved enormously, markets have reopened, both senior and secure markets, covered bond markets, and even the interbank market – although still limited to the short term and to national boundaries – has also started working a little better. Certainly, we see many signs of a return of confidence in the euro. So-called real money investors have, to some extent, come back. We see the presence of money market funds, which were the first to take flight from the euro a year and a half ago. We see again pension funds, we see investment funds – so, all in all, we see that great progress has been achieved. ... basically, the LTRO had the powerful effect of removing what is called "tail risk" from the environment".⁴

2.2.5. What will happen next

It is apparent that the ECB's unconventional monetary policy measures were a success in that they calmed turbulent financial markets in the short run. Undoubtedly some of this success was due to the action being perceived as a signal. It was not as successful as it might have been in increasing bank lending to the real sector, however, as much of the additional liquidity appears to have been parked at the Eurosystem deposit facility, as shown in Figure 6.

Figure 6. Eurosystem Deposit Facility (EUR billions)



Source: ECB

If the ECB is sufficiently forceful in doing what it takes to support sovereign debt markets, banks that took part in the LTROs may be further tempted into the carry trade. If market participants can be persuaded that the sovereign debt crisis is under control then the economic outlook will improve, Mario Draghi's protestation that the increase in funds in the Eurosystem's deposit facility is temporary will turn out to be correct and the retail bank

⁴ Press Conference, 8 March 2012

lending market will recuperate. If market participants adopt a less sanguine view, then in the long term the new LTROs are likely to be – at best -- just another example of ineffectual credit easing.

3. THE CHANGE IN COLLATERAL RULES

On 12 Dec 2011 the Governing Council announced that NCBs are allowed, as a temporary solution, to accept as collateral for Eurosystem credit operations additional performing credit claims that satisfy specific eligibility criteria. The responsibility for accepting such credit claims is to be borne by the National Central Bank (NCB) authorising their use. Seven NCBs, those of Ireland, Spain, France, Italy, Cyprus, Austria and Portugal, put forward proposals and these were approved by the Governing Council on 9 February 2012.⁵

The new collateral rules have two significant features. First, collateral rules can now vary across countries. Second, while previously the losses from all Eurosystem operations undertaken for monetary policy purposes were shared across the Eurosystem according to ECB capital shares, the losses associated with a central bank now having collateral rules that are more lenient than that of the rest of the Eurosystem are to borne by that central bank.

There are two potentially undesirable consequence of this easing of standards. First, domestic banks in a country with abundant easy liquidity face a reduced incentive to clean up their balance sheets.

Second, while it has always been possible for a NCB to become insolvent, the new rules increase the likelihood of this happening. Given the Eurosystem's current full-allotment procedures, an imprudent national central bank could sustain substantial losses. Suppose that a NCB did become insolvent. Its national government would be expected to recapitalise it, but if the sovereign itself were in dire straits this might not be possible. Under current rules, banks headquartered in that NCB's country would then not be able to borrow from the Eurosystem. ECB policy makers would face the politically unpleasant question of whether to allow a national banking to fail or whether to have the rest of the Eurosystem absorb the losses.

⁵ Details of the proposals are on the NCBs websites. The central banks of Portugal, Cyprus, Spain, Italy and Austria lowered allowable credit quality by raising their acceptable probabilities of default. The central banks of France, Cyprus and Spain have permitted credit claims denominated in currencies other than the euro. The central banks of Ireland and France have said they will start accepting real estate and mortgage-backed loans and the central banks of Portugal and Cyprus lowered the minimum size.

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