

Global Economics View

ELA Revisited: A Clarification

- This note clarifies and corrects some comments previously circulated in "ELA: An Emperor without Clothes?", Citi Global Economics View and Euro Weekly, 21 January 2011
- Liabilities issued by national central banks (NCB) as a result of Emergency Liquidity Assistance (ELA) operations are Eurosystem liabilities.
- Any profits or losses made from the collateralised lending of NCBs under their ELA facilities are for the account of the NCB alone and are not shared/ pooled with the rest of the Eurosystem.
- Exposure of an NCB as a result of ELA likely carries a guarantee of that NCB's sovereign and implies shift of credit risk from the Eurosystem to Euro Area (EA) sovereigns.
- In the case of an insolvent EA sovereign, such guarantees would be irrelevant without external support for the sovereign, and the credit risk *de facto* would remain with the Eurosystem. As a consequence the ELA is a dilution of the collateral and counterparty requirements of the Eurosystem.

Willem Buitter

+44-20-7986-5944
willem.buitter@citi.com

Jürgen Michels

+44-20-7986-3294
juergen.michels@citi.com

Ebrahim Rahbari

+44-20-7986-6522
ebrahim.rahbari@citi.com

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ELA Revisited: A Clarification

The last paragraph of "ELA: An Emperor without Clothes?", by Willem Buiter, Jürgen Michels and Ebrahim Rahbari, *Citi Global Economics View and Euro Weekly*, 21 January 2011 contains a question and an incorrect conjecture.

Liabilities issued by a national central bank (NCB) that is part of the Eurosystem are Eurosystem liabilities.

In the paragraph we questioned why banks would accept Emergency Liquidity Assistance (ELA) liabilities issued by the Central Bank of Ireland (CBI). In the meantime, we received more information strongly suggesting that the liabilities issued by a national central bank (NCB) that is part of the Eurosystem, like the CBI under its emergency liquidity assistance (ELA) facility, *are* Eurosystem liabilities.

As discussed in our previous notes, the Statute of the ESCB and the ECB given the ECB Governing Council the right to veto any actions of NCBs outside their ESCB functions with a two-thirds majority. The veto option also implies that the ECB can establish conditions for the continuance of such actions, and, e.g. in the case of ELA, set thresholds for authorisation and notification.

Thus, the liabilities created by the Central Bank of Ireland as a result of its Emergency Liquidity Assistance (ELA) operations are Eurosystem liabilities.

If the NCB funds its ELA lending by issuing *reserves*, that is, by increasing the size of the current account balances or of deposit facility balances held with it by eligible counterparties, these reserves (current accounts or overnight deposits) are part of the 'Base money' of the Eurosystem. The ECB defines Base money as 'banknotes in circulation' plus 'current accounts, (covering the minimum reserves system)' plus the 'deposit facility'.

If instead the NCB funds its ELA lending by issuing non-monetary liabilities, i.e. liabilities which are not included in the categories above, say one-week term deposits (the same liabilities that are used by the Eurosystem to 'sterilise' the purchases of securities it engages in under its Securities Markets Programme (SMP)), then these liabilities will not constitute Base money of the Eurosystem, but they are still (non-monetary) liabilities of the Eurosystem. A third option would be for the NCB to fund ELA lending by selling assets.

Even if the CBI decides to fund its ELA activities through increases in the current accounts or in the deposit facility, the Eurosystem as a whole can, in principle, offset or sterilise the effect of the CBI's ELA facilities through an increase in the non-monetary liabilities of the Eurosystem (say, through an increase in weekly term deposits) and a matching reduction in the monetary liabilities of the Eurosystem ex-CBI. As we explained in our earlier note, under the current full allotment regime of liquidity management, it is not possible to restrict the provision of Eurosystem Base money directly to keep constant the stock of base money in the Eurosystem as a whole, should a national central bank like the CBI decide to fund its ELA operations by increasing the base money issued by the CBI.

ELA is likely funded by increases in Base money – even if Base money on the balance sheet of the CBI does not show such an increase.

In the present Irish case, no public information is provided about how the CBI funds ELA lending. The CBI does publish the components of Base money in its monthly financial statements. A comparison of the year-end statements shows that while 'Other assets', which include ELA lending, increased by €37.6bn between December 2009 and December 2010 (from €13.5bn to €51.1bn), Base money actually *decreased* by €2.4bn. At the same time, 'Other Liabilities' on the CBI balance sheet increased by €69.6bn at the end of 2009 to €162.2bn.¹ At face value, the reading of the financial statement of the CBI thus suggests that ELA is mainly or even wholly funded by issuing non-monetary liabilities.

¹ The December 2010 financial Statement of the CBI shows that, since December 2009, 'Banknotes in circulation' have increased from €12,219m to €12,293m, 'Current accounts (covering the minimum reserve system)' have decreased from €8,840m to €8,264m and balances on the 'Deposit Facility' have decreased from €5,053m to €3,150m, implying a total decrease of €2,405 in Base money on the balance sheet of the CBI of €5,305m. 'Other assets' on the other hand, which include ELA lending, increased by €37,620m, from €13,474m to €51,094m.

However, in our view, such an interpretation would not be correct. The reason lies in the nature of that very balance sheet item 'Other liabilities'. As noted in notes 27 and 28 of the financial statements in the Annual Report 2009 of the CBI, 'Other liabilities' mainly represent intra-Eurosystem liabilities that result, for instance, from shifts of deposits from a bank in Ireland to a bank in Germany. In that case, the CBI would record a decrease in current account or deposit liabilities (Base money) and an increase in liabilities to the Bundesbank (which would be counted in 'Other liabilities' on the CBI's balance sheet). Shifts of deposits out of the Irish banking system have, of course, been widely documented over the past few months. Thus, it is certainly possibly – in fact, plausible, in our view – that ELA granted by the CBI is funded mainly by increasing Base money, while Base money shown on the CBI balance sheet does not show a commensurate increase or even a decrease because of deposit flight from Irish banks to German banks. Note that a transfer of deposits from an Irish to a German bank would show up on the Bundesbank balance sheet as an increase in "Other Assets" (claims on the CBI) and an increase in the monetary and/or non-monetary liabilities to German banks.

In the case of Ireland, it is also noteworthy that, for the last observation for which the financial statements of the CBI recorded a substantial increase in 'Other Assets', the evolution of Base money also supports the hypothesis that ELA is in fact funded mainly by increases in base money.² In the earlier case of ELA of €20bn granted by the German Bundesbank in September/October 2008, the Bundesbank balance sheet also showed a temporary increase in the monetary liabilities (Base money) during the period in which the ELA was provided.

The collateralised loans made to Irish banks by the CBI under the CBI's ELA are not part of the Eurosystem's assets to which Eurosystem-wide profit and loss sharing applies. So any profits or losses made from the collateralised lending of the CBI under its ELA facility are for the account of the CBI alone. The capital of the CBI at the end of January 2011 was reported to be €1,531mn.³ The total amount of collateralised loans outstanding at that time under the CBI's ELA was probably around €49bn. It is therefore certainly possible that the CBI would incur losses on its ELA exposure that would wipe out its capital. With this kind of leverage, a private sector credit institution would breach all capital adequacy rules for private sector banks. However, NCBs are not under any regulatory obligation to maintain a certain level of own funds.

Irish Independent reported that ELA was provided at interest rates 'in the 'ball park' of 2% to 3%' and for (renewable) windows of up to seven days.

An article in the Irish Independent on 8 February 2011 contained further information on the terms under which ELA was provided by the CBI.⁴ According to quoted sources that asked to remain confidential, the interest rate paid by Irish banks is 'in the 'ball park' of 2% to 3%'. It would thus carry a penalty over the ECB's marginal lending facility which currently stands at 1.75% and is much higher than the 1% currently charged for the usual seven-day refinancing

² Between November and December 2010, Base money on the balance sheet of the CBI increased by €5,305m, while Other Assets – our proxy for ELA – increased by €6,420m. All of our interpretations above which rely on readings of balance sheets are subject to the usual caveat that without knowledge of the counterfactual – the evolution of monetary base in the absence of ELA – an unchanged level of total Base money does not conclusively show that ELA did not raise Base money, as total Base money may have decreased in the absence of ELA lending. The latest available statement, published on February 11, 2011, shows an insignificant increase of 'Other Assets' of only €28,000, while Base money decreased by €3,541m and 'Other liabilities' decreased by €11,495m.

³ Central Bank of Ireland, Quarterly Bulletin, 2011 Q1, January 31, 2011, Table A.2.

⁴ <http://www.independent.ie/business/irish/banks-pay-less-than-3pc-interest-on-euro51bn-of-emergency-funding-2529378.html>

operations of the Eurosystem, but is significantly below the interest rate of 5.7% the Irish sovereign pays on funds borrowed as part of its IMF/EU bailout. The interest rate penalty would also be much lower than that applied to Fortis when it received €61bn of emergency loans from the Belgian and Dutch central banks (at a rate of Libor plus 500bps for dollar funding, possibly 100bp less for euro funding).⁵ The Irish Independent article also stated that ELA would typically be granted for a maximum of seven days, but could be renewed.

According to Reuters, Anglo Irish Bank reported on Tuesday that its central bank borrowings amounted to €45bn at the end of 2010 of which €28.1bn were borrowed under the 'Irish central bank's special liquidity facilities'.⁶ As mentioned in our previous note, it has been suggested that much of this emergency lending has been against promissory notes that were offered to various Irish financial institutions by the Irish sovereign, mainly in exchange for assets that were transferred to the NAMA. These promissory notes account for a total of €31bn (€25.3bn for Anglo Irish Bank, €5.4bn to Irish Nationwide Building Society and €250m to Educational Building Society). Since these promissory notes were issued by the Irish sovereign and are already accounted for in the public accounts, the increase in the 'true' (not the official) consolidated general government Irish gross debt as a result of ELA would be somewhat smaller than the headline €49bn or so – how much smaller depends on the amount of lending granted against such collateral. At a minimum, the increase in Irish general government gross debt would be around €18bn (€49bn minus the value of the entire stock of promissory notes outstanding, €31bn, implying zero haircuts to be applied to the collateral).

We assume that the Irish state provides a full guarantee/indemnity to the CBI for its ELA exposure.

Such a guarantee implies that credit risk of funding Irish banks moves from the Eurosystem to the Irish sovereign.

The size of the Irish bail-out package remains small relative to the likely future funding needs of the Irish sovereign that the markets are unwilling to accommodate on acceptable terms. We previously estimated that the €50bn provided in the bail-out as budgetary support would fund the Irish sovereign for just over two three years – our estimate in early January 2011 for the three year gross financing requirement of the Irish general government was €68bn, a number that would rise by up to €9bn if the principal payments for the promissory notes issued by the Irish sovereign and discussed above were included. And additional future capital needs of the banking sector may yet further raise sovereign financing requirements – Anglo Irish chairman Alan Dukes said on 8 February 2011 that €15bn of capital may be needed to recapitalise the Irish banking sector *in addition to the €35bn earmarked in the bail-out facilities*.⁷ This is in addition to the €50bn provided by the Irish sovereign to recapitalise the Irish bank prior to Ireland accepting the IMF/EU financial rescue package – making a total sovereign contribution to Irish bank recapitalisation of €100bn.

We assume that the ELA lending by the CBI is subject to a full guarantee/indemnity by the Irish government, an assumption confirmed by the Irish Independent article cited above. If the Irish government is solvent, the Irish ELA facility therefore provides a mechanism through which the Eurosystem can shift the counterparty and credit risk of lending to Irish banks to the Irish sovereign. This, indeed, is the purpose of the ELA. When a bank requires additional Eurosystem liquidity but is no longer, at the margin, a fully eligible counterparty to the Eurosystem, either because the ECB/Eurosystem views the

⁵ See <http://ftalphaville.ft.com/blog/2011/02/08/482281/irelands-secret-liquidity-is-unbelievably-cheap/>

⁶ <http://www.reuters.com/article/2011/02/08/ireland-ecb-idUSLDE7172ER20110208>

⁷ <http://www.independent.ie/national-news/dukes-we-need-euro15bn-more-to-save-the-banks-anglo-chief-warns-we-face-asking-imf-for-extra-40pc-2531404.html>

Should the Irish sovereign itself be insolvent, no such shift of the credit risk is possible and the credit risk remains with the Eurosystem – and likely dilutes its standards for counterparty and collateral eligibility

bank as de-facto insolvent or because the bank does not have any acceptable collateral it can offer the NCB of that bank can at its own risk (or rather at the risk of its sovereign), provide that bank with Eurosystem liquidity via ELA, if it is not vetoed by a two thirds majority of the Governing Council of the ECB.⁸

However, when the sovereign that guarantees the national central bank's exposure under the ELA is itself likely to be insolvent (and when the NCB's capital and reserves are puny), it is not in fact possible to provide a credible guarantee/indemnity for that national central bank's exposure under the ELA. The risk that the collateralised loans made under the ELA will go bad cannot in fact be shifted to the NCB and its sovereign. If there is no external support for the sovereign available (say from the European rescue facilities), the counterparty and credit risk instead will likely remain with the Eurosystem, and are forcibly pooled by the other members of the Eurosystem.

When an NCB with limited capital provides liquidity to banks in its jurisdiction through its ELA facility under a guarantee/indemnity provided by a government that is illiquid and probably de-facto insolvent, all that happens is that the ELA becomes a mechanism through which the Eurosystem dilutes its standards for counterparty eligibility and collateral eligibility. Any losses resulting from CBI lending under its ELA facility to likely insolvent banks offering as collateral securities issued or guaranteed by a sovereign that is also likely to be insolvent, will be for the account of the Eurosystem as a whole. It turns the Eurosystem from a provider of liquidity to solvent banks into a provider of capital, that is, of solvency support, for likely insolvent banks.

A final open question is how the Governing Council of the ECB enforces its veto over the ELA activities of one of its NCBs. What happens if the Governor of the NCB 'goes native' and decides to continue to expand the size of its ELA facility despite a veto by the Governing Council? What are the legal and de-facto enforcement powers of the ECB and its Governing Council over individual NCBs? What bailiffs would be sent in?

⁸ Note the ECB has extended the rules to limit the use of its lending facilities to specific counterparties in September 2010. See <http://www.ecb.int/press/pr/date/2010/html/pr101009.en.html>

Appendix A-1

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