

Frozen Europe Means ECB Must Resort to ELA

By Dara Doyle and Jeff Black - May 24, 2012

The first rule of ELA is you don't talk about ELA.

The European Central Bank is trying to limit the flow of information about so-called Emergency Liquidity Assistance, which is increasingly being tapped by distressed euro-region financial institutions as the debt crisis worsens. Focus on the program intensified last week after it emerged that the ECB moved some Greek banks out of its regular refinancing operations and onto ELA until they are sufficiently capitalized.

European stocks fell and the euro weakened to a four-month low as investors sought clarity on how the Greek financial system would be kept alive. The episode highlights the ECB's dilemma as it tries to save banks without taking too much risk onto its own balance sheet. While policy makers argue that secrecy is needed around ELA to prevent panic, the risk is that markets jump to the worst conclusion anyway.

"The lack of transparency is a double-edged sword," said David Owen, chief European economist at Jefferies Securities International in London. "On the one hand, it increases uncertainty, but at the same time we do not necessarily want to know how bad things are as it can add fuel to the fire."

Under ELA, the 17 national central banks in the euro area are able to provide emergency liquidity to banks that can't put up collateral acceptable to the ECB. The risk is borne by the central bank in question, ensuring any losses stay within the country concerned and aren't shared across all euro members, known as the euro system.

ECB Approval

Each ELA loan requires the assent of the ECB's 23-member Governing Council and carries a penalty interest rate, though the terms are never made public. Owen estimates that euro-area central banks are currently on the hook for about 150 billion euros (\$189 billion) of ELA loans.

The program has been deployed in countries including Germany, Belgium, Ireland and now Greece. An ECB spokesman declined to comment

on matters relating to ELA for this article.

The ECB buries information about ELA in its weekly financial statement. While it announced on April 24 that it was harmonizing the disclosure of ELA on the euro system's balance sheet under "other claims on euro-area credit institutions," this item contains more than just ELA. It stood at 212.5 billion euros this week, up from 184.7 billion euros three weeks ago.

The ECB has declined to divulge how much of the amount is accounted for by ELA.

Ireland's Case

Further clues can be found in individual central banks' balance sheets. In Ireland, home to Europe's worst banking crisis, the central bank's claims on euro-area credit institutions, where it now accounts for ELA, stood at 41.3 billion euros on April 27.

Greek banks tapped their central bank for 54 billion euros in January, according to its most recently published figures. That has since risen to about 100 billion euros, the Financial Times reported on May 22, without citing anyone.

Ireland's central bank said last year it received "formal comfort" from the country's finance minister that it wouldn't sustain losses on collateral received from banks in return for ELA.

"If the collateral underpinning the ELA falls short, the government steps in," said Philip Lane, head of economics at Trinity College Dublin. "Essentially, ELA represents the ECB passing the risk back to the sovereign. That could be the trigger for potential default or, in Greece's case, potential exit."

Greek Exit

The prospect of Greece leaving the euro region increased after parties opposed to the terms of the nation's second international bailout

dominated May 6 elections. A new vote will be held on June 17 after politicians failed to form a coalition, and European leaders are now openly discussing the possibility of Greece exiting the euro.

A Greek departure could spark a further flight of deposits from banks in other troubled euro nations, according to UBS AG (UBSN) economists, leaving them more reliant on funding from monetary authorities. Banks in Greece, Ireland, Italy, Portugal and Spain saw a decline of 80.6 billion euros, or 3.2 percent, in household and corporate deposits from the end of 2010 through March this year, according to ECB data.

“ELA is a symptom of the strain in the system, and Greece is the tip of the iceberg here,” Owen said. “As concerns mount about break-up, that sparks deposit flight. Suddenly we’re talking about 350 billion, 400 billion as bigger countries avail of ELA.”

German ELA

ELA emerged as part of the euro system’s furniture in 2008, when the global financial crisis led to the bailouts of German property lender Hypo-Real Estate AG and Belgian banking group Dexia. While the Bundesbank’s ELA facility has now been closed, Dexia Chief Executive Officer Pierre Mariani told the bank’s shareholders on May 9 that it continues to access around 12 billion euros of ELA funds.

ELA was a measure that gave central banks more flexibility to keep their banks afloat in situations of short-term stress, said Juergen Michels, chief euro-area economist at Citigroup Global Markets in London.

“It seems to be now a more permanent feature in the periphery countries,” Michels said, adding there’s a risk that “the ECB loses control to some extent over what’s going on.”

The ECB was forced to confirm on May 17 it had moved some Greek banks onto ELA after the news leaked out, roiling financial markets. The ECB said in an e-mail that as soon as the banks are recapitalized, which it expected to happen “soon,” they will regain access to its refinancing operations. The ECB “continues to support Greek banks,” it added.

‘Life Support’

By approving ELA requests, the ECB is ensuring that banks that would otherwise not qualify for its loans have access to liquidity.

“The ELA is a perfect life-support system, but it’s not a system for what happens after that,” said Lorcan Roche Kelly, chief Europe strategist at Trend Macrolytics LLC in Clare, Ireland. “What you need is a bank resolution mechanism, a method to get rid of a bank that’s insolvent. In Ireland, and perhaps in Greece as well, the problem is that you’ve got banking systems that are insolvent.”

For Citigroup chief economist Willem Buiter, there is a bigger issue at stake. ELA breaks a key rule that is designed to bind the monetary union together, he said.

“It constitutes a breach of the principle of one monetary, credit and liquidity policy on uniform terms and conditions for the whole euro system. The existence of ELA undermines the monetary union.”