



## ECB Policies Ease Euro Area Funding Pressures

### Commentary Highlights

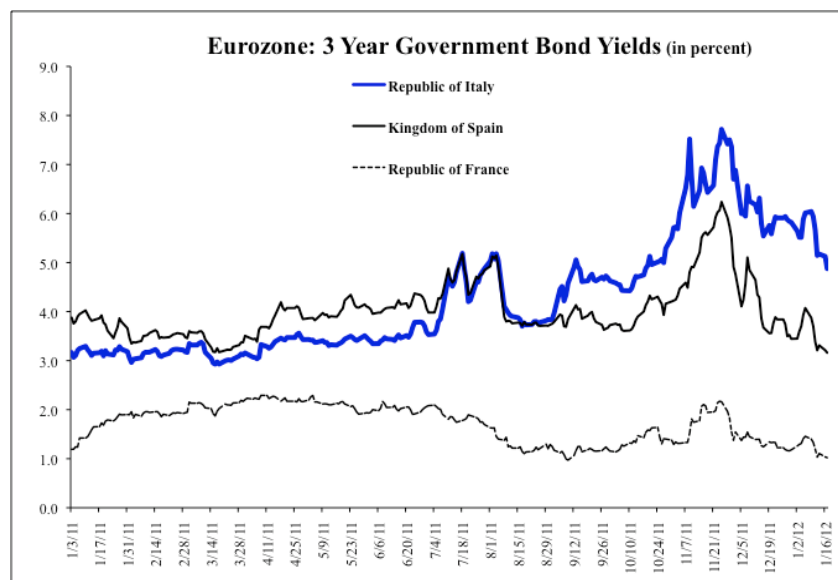
- Recent ECB measures have eased bank funding stress in the Euro area.
- However, downside risk is significant and bond prices remain under pressure, not least because of uncertainty over the Greek debt exchange.
- Nevertheless, while no panacea, ECB liquidity support to banks is positive for stabilising European financial markets and creating the conditions for growth, and averts a direr outcome for the Euro area.

### ECB Loans Have Eased Bank Funding Stress

On December 21, the European Central Bank extended €489.1 billion in 36-month fixed-term one percent longer-term refinancing operations, or LTROs, to Euro area banks. This was the most significant of a series of new measures announced in December to support bank lending and provide liquidity to the money market. The ECB plans to extend a second set of LTROs on February 29, by which time collateral requirements that banks need to pledge in return for the loans will be relaxed, allowing a greater number of financial products to be eligible. **DBRS views this liquidity as a strong signal of political support for Euro area banks. It establishes the ECB as the ultimate purchaser of bank bonds, and is instrumental in stabilising European financial markets.**

European banks appear to have tapped the LTROs largely to refinance maturing debt. Approximately €200 billion in bank bonds are due to mature in the first quarter of 2012, €150 billion in the second quarter and €290 billion in the second half of the year. Meeting bank funding is relevant because banks account for approximately four-fifths of the European credit market. Once banks cover their funding needs, perhaps through 2012 or even 2013, the hope is that they will resume lending to other banks and extend credit to firms and households, providing a lift to economic activity.

Recent sovereign bond pricing also suggests that the LTRO could be having a positive effect on the short- and mid-end of the sovereign yield curve. Since the LTRO offering, there is some evidence that equivalent three-year sovereign bond yields have declined. After all, the one-percent LTROs provide a big incentive for banks to purchase higher yielding sovereign bonds of up to three years.



Source: Bloomberg, DBRS



### **Risks Remain to the Downside**

However, bank demand for the long-end of the sovereign yield curve has remained limited, and downward pressure on sovereign bond prices continues. Furthermore, there is little evidence that banks are extending senior loans to corporates or lending to other banks in the short-term interbank market, and the supply of credit remains constrained. Although the unsecured bank bond market has shown some signs of revival, banks are building up cash reserves and depositing funds at the ECB for a return of only 0.25%. Overnight deposits at the ECB reached a record high of €493 billion on January 17. There are likely two main reasons why banks continue to curtail lending: the need to raise capital and general risk aversion.

### ***Strengthening Bank Capital***

The hesitancy by banks to extend credit can partly be explained by new European Banking Authority recapitalisation recommendations. The EBA has recommended that national central banks require banks to strengthen their capital positions by building up temporary capital buffers against sovereign debt exposures to reflect market prices as of the end of September 2011. Some banks have also absorbed write-downs on one-half of the value of their holdings of Greek debt. Banks are also required to build a temporary buffer by raising their Core Tier 1 capital ratio to 9% by the end of June 2012. The aggregated shortfall amounts to €14.7 billion, and banks must submit to the EBA plans for how they will achieve these targets by January 20. Banks are achieving this by curtailing lending and selling assets, preferring to shrink their balance sheets to reduce their funding needs, effectively contributing to the deceleration of economic activity. The OECD is forecasting that Euro area GDP will decelerate from 1.6% in 2011 to 0.2% in 2012, while consensus expectations estimate that Euro area GDP will contract by 0.2% in 2012.

### ***Risk aversion persists***

As banks strengthen their capital positions, sovereign bond redemptions, delays in the Greek debt exchange, and the difficulty of implementing fiscal consolidation and structural reform in the midst of a weakening economic environment have contributed to risk aversion. This is evident in continued high sovereign bond spreads and a weakening Euro, while capital continues to flow into the haven assets of U.S. Treasury bonds, U.K. gilts and German bunds, driving down these yields to near historical levels.

In 2012, European sovereigns owe approximately €1.2 trillion in redemptions, of which approximately €200 billion come due in the first quarter. An additional €300 billion in short-term bills for all sovereigns also come due in the first quarter. Approximately €300 billion of Italian bonds come due during the year. Italy and Spain's financing needs for 2012 and 2013 alone come to a very high €1.1 trillion.

As sovereigns roll their debt, Greece has until March 20 to reach an agreement with its creditors, when €14.4 billion in bond redemptions come due. The key assumption of the current IMF and EU programme, which in return for aid aims to reduce Greek debt-to-GDP to 120% by 2020, is a near-100% rate of participation by private sector holders of Greek bonds in a debt exchange in which they agree to a 50% reduction on the face value of their bonds. The negotiations have stalled due to (1) disagreements over whether to honour the 50% reduction or to apply a larger haircut, (2) the duration of the new bonds, with general discussion between 20-30 years, and (3) the coupon payments on the new bonds. A fourth complication is the difficulty the Greek government faces in continuing to implement fiscal consolidation in the midst of a deep recession. The IMF estimates that Greek GDP will decline by 2.7% in 2012, the fourth consecutive year of contraction.



Classified as voluntary, the Greek debt exchange has actually resulted in higher risk premiums to compensate for the added risk. This is because many creditors also own credit default swaps, but which, given the voluntary classification, will not be triggered and creditors will not be reimbursed by CDS contracts. A larger concern is that the conditions of the Greek exchange might be applied to other distressed Euro area sovereigns. Although Euro area governments ruled this out on December 5, investor doubts remain, with clear ramifications for DBRS's sovereign ratings in the Euro area should other countries be given the same treatment. DBRS believes that if an agreement between Greece and its creditors is not reached soon, Greece could well miss its March 20 payment and default.

### **Liquidity – No Panacea but Stabilising**

In the presence of these stresses, massive ECB liquidity support to banks, and indications that it stands ready to provide further liquidity, suggest that funding relief for banks has become virtually unlimited. This should help to stabilise European financial markets, and is a necessary step to creating the conditions for higher growth and job creation, without which attempts at fiscal consolidation and structural reforms to enhance competitiveness will be futile.

The limited ECB Securities Markets Programme (SMP) purchases of sovereign bonds in secondary market auctions have also helped to stabilise bond prices. However, long-term yields remain at distressed levels and far greater purchases may be needed to offset low market appetite if banks do not increase their purchases in the coming weeks and months.

So far, the ECB has on a weekly basis sterilised the amount of asset purchases from government debt markets; in other words, withdrawn the liquidity it pumped into the market by buying sovereign bonds. Standing in the way of more ECB sovereign debt purchases are limitations on the amount of money that the ECB believes it is able to drain from the banking system in order not to increase the money supply and stoke inflation. This policy contrasts with those of the U.S. Federal Reserve and Bank of England, whose quantitative easing debt programs aim to increase bank reserves and cash in the banking system for the express purpose of increasing the money supply to promote economic growth, despite the risk of higher inflation.

DBRS believes that in the absence of more bank purchases of sovereign bonds, greater ECB intervention in the secondary debt markets is likely. DBRS perceives that the ECB could set a ceiling for sovereign bond yields, defend these yields by announcing its willingness to conduct greater debt purchases, and thereby stabilise the sovereign debt markets and lower interest costs for governments. Through January 13, the ECB had provided €16.8 billion in weekly secondary market debt purchases through its SMP, a relatively small amount compared to the amount of government securities outstanding, but a very large amount to sterilise.

### **Conclusion**

DBRS believes that the ECB possesses the resources to continue to stabilise government securities markets and prevent a dire outcome in the Euro area. Greater market liquidity, through the LTRO and SMP could help to further stabilise interbank and credit markets if investor perceptions regarding the risk of holding sovereign debt declines. Funding to governments encountering rollover difficulties could also provide a ceiling for bond yields. This, in turn, could provide countries with some breathing room to focus on promoting growth, cutting their deficits and implementing structural reforms. However, the immediate investor concerns, most notably the Greek debt exchange, would likely need to be more fully addressed for this to occur.



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