

INTELLECTUAL AMMUNITION

Understanding ELA: Emergency Liquidity Assistance

Friday, July 15, 2011

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How the ECB lets national central banks of the Eurosystem do the dirty work.

Today will see the release of [the results](#) of the latest round of European bank stress tests. It is timely to look at the support European banks have received since the start of the global financial crisis in 2008, and the unusual nature of one particular form of that support -- emergency liquidity assistance (ELA).

The [European Central Bank \(ECB\)](#) has been providing liquidity to European banks on a "fixed rate full allocation" basis since October 2008. This, combined with extended maturities on refinancing operations, an extension of eligible collateral for those operations and a €60 billion covered bond purchase program, has meant that *solvent* European banks have been able to access sufficient liquidity throughout the crisis.

However, when a bank is suffering from a crisis of *solvency*, rather than *liquidity*, the ECB washes its hands of the matter. The ECB's [2008 annual report](#) states that "During a solvency crisis, the main responsibility for crisis management and resolution is borne by the finance ministries that decide on the possible provision of financial support, and by **the supervisory authorities that may take exceptional supervisory measures** to stabilize the troubled institution or decide to wind it down." (Emphasis TrendMacro's)

In this statement, the "supervisory authority" means the national central bank (NCB) of the Euro area nation where a given insolvent bank is located -- the NCBs together comprise the European System of Central Banks. And the "exceptional supervisory measure" means emergency liquidity assistance (ELA).

ELA is expected to be used only in extremis by an NCB. It is also, as the name suggests, meant to be temporary. The Belgian National Bank provided ELA -- [including US funding](#) -- of €51 billion during September and October 2008, while the Bundesbank also used ELA during this period, peaking at €38 billion in October 2008.

Update to strategic view

EUROPE MACRO, ECB: Emergency liquidity assistance (ELA) is a monetary policy tool unique to the Euro area, reflecting the paradox of a currency union without a political union. ELA amounts to quantitative easing of the euro -- a supranational currency -- executed at a national level. It is an important safety valve for the banking systems of peripheral nations. Ireland has been the largest user of this facility, but now hopelessly insolvent Greece is set to make use of ELA to save its banking system from collapse.

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— Extraordinary Liquidity Assistance (ELA) in Ireland Central Bank of Ireland "Other Assets," € millions



Source: Central Bank of Ireland

However, The NCB that has been making the most use of ELA to support its insolvent banks is the Central Bank of Ireland. It reports the level of ELA provided in the "other assets" column of its [monthly financial statement](#) (please see chart above). Incidentally, the "other assets" category is a catch-all including many types of instruments, so detecting ELA on the balance sheets of Euro area NCB's can be tricky.

There are two notable legs up in the volume of the CBI's ELA. The first comes in March 2009, following the nationalization of Anglo Irish Bank -- the second in October 2010 following the expiration of the original Irish government bank guarantee.

More important for our analysis is the collateral the CBI accepts from the banks for ELA operations. The 2010 [annual report](#) of the CBI provides a breakdown

- *Promissory notes issued by the Minister for Finance.* The Irish Minister for Finance recapitalized Anglo Irish Bank and Irish Nationwide with promissory notes valued at €30.8 billion. These unlisted instruments are not eligible collateral for ECB monetary policy operations.
- *Master Loan Repurchase Deeds.* These are repurchase agreements for securities backed by investment and development loans that are not eligible collateral for ECB operations.
- *Framework agreements in respect of Mortgage Backed Promissory Notes.* A mortgage back promissory note is known as "[The Irish Variant.](#)" It consists of a pool of non-securitized residential mortgages.
- *Special Master Repurchase Agreements.* Repurchase agreements covering collateral no longer eligible for ECB operations, not covered by Master Loan Repurchase Agreements above.

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- *Facility deeds.* These are the strangest of the instruments accepted by the Irish Central Bank. It is described on page 95 of Anglo's [annual report](#) as "an unsecured loan facility guaranteed by the Minister for Finance." Basically, it is a letter from the Minister for Finance declaring that Anglo Irish Bank (or any other bank using the facility deed) is good for a loan from the Central Bank of Ireland.

The CBI has received formal comfort from the Irish Minister for Finance that any shortfall on the liquidation of collateral is made good. This means that the Irish Minister for Finance has a large contingent liability that is only partially accounted for. Eurostat -- the European data agency equivalent to the US Bureau of Economic Analysis -- insisted that the full €30.8 billion of the promissory notes was added to Ireland's 2010 budget deficit, meaning it reports Ireland's 2010 deficit at 32% of GDP. There is no provision for the rest of the outstanding ELA balance.

This means that rather than getting its hands dirty engaging directly in quantitative easing, the ECB manages to make sure that such operations are conducted in national central banks and at the sole liability of the respective individual nation's government. It can be argued that the ECB [Securities Market Programme](#) (SMP) -- under which the ECB has bought €74 billion in peripheral nations' debt -- is quantitative easing, but the ECB maintains that its weekly liquidity absorbing operation equaling the outstanding value of the SMP means the operation is liquidity neutral.

Recent developments in Greece mean that we will be hearing more about ELA in the coming weeks and months. We recently pointed to the possibility of the Bank of Greece engaging in ELA (see "[Black Wednesday in Greece](#)" June 16, 2011), with our suspicions confirmed by comments made by ECB President Jean Claude Trichet at the press conference following the July rates decision (see "[On Europe's July Rate Decisions](#)" July 7, 2011).

The fourth [IMF review of Greece](#), published yesterday, directly supports our view, saying "Liquidity support, if necessary, could be delivered via the previously agreed €30 billion tranche of government-guaranteed bank bonds and via direct support from the BoG, funded through emergency liquidity operations, mainly ELA."

The Bank of Greece is a [publicly traded company](#), listed on the stock exchange. In order to ensure the Greek government has sole liability for its ELA operations, the Greek parliament passed [legislation in May](#) to guarantee the Bank of Greece's exposure stemming from this support.

We will only be able to confirm that the Bank of Greece is engaged in ELA by watching its [balance sheet](#) for unusual growth. The ECB does not report individual central bank ELA operations. They are -- as is the case for the Central Bank of Ireland outlined above -- reported *only* on national central bank balance sheets.

Emergency liquidity assistance has two important policy implications:

- ELA is quantitative easing of a supranational currency applied on a national level, at the discretion of a national authority. As such, it is an important policy safety valve for peripheral nations with imperiled banks, offsetting the excessive tightness of the ECB.
 - So for strategic analyses of liquidity conditions in Europe -- such as might support a view on growth, or on the gold price (see "[Plan B-Plus for Gold](#)" July 14, 2011) -- one cannot look only at the ECB's balance sheet. One must look at the balance sheets of all the separate NCB's that make up the European System of Central Banks.
- ELA adds to the contingent liabilities of the respective national governments -- not to the liabilities of the ECB. But because it is a contingent liability, is not included in that country's debt calculations.
 - So for strategic analysis of the fiscal conditions of European nations, one cannot look only at each nation's outstanding debt securities. One must also look at the sovereign's contingent liabilities arising from potential losses in the collateral supporting ELA.

Bottom line

Emergency liquidity assistance (ELA) is a monetary policy tool unique to the Euro area, reflecting the paradox of a currency union without a political union. ELA amounts to quantitative easing of the euro -- a supranational currency -- executed at a national level. It is an important safety valve for the banking systems of peripheral nations. Ireland has been the largest user of this facility, but now hopelessly insolvent Greece is set to make use of ELA to save its banking system from collapse. ▶