

Box 2

RECENT DEVELOPMENTS IN THE BALANCE SHEETS OF EURO AREA CREDIT INSTITUTIONS

Since the onset of the financial turmoil in the summer of 2007 credit institutions across the globe have faced mounting pressures regarding the size of their balance sheets. Institutions in the euro area have not been immune to these pressures, which in broad terms stem from two sources. On the one hand, some institutions have suffered an erosion of their capital base, for instance owing to credit losses or adverse movements in asset prices. This could require such institutions to reduce the size of their balance sheets, in order to return the ratio of total assets to capital to the required or desired level.¹ On the other hand, tensions in the money markets and investors' apprehension in other markets where credit institutions typically obtain funding (such as the covered bond, securitisation and unsecured debt markets) mean that at least some of these institutions are facing funding constraints as regards their capacity to expand and indeed maintain the size of their balance sheets. Depending on how any downsizing of credit institutions' balance sheets is implemented, this could have implications for euro area firms and households' access to financing. Against this background, this box examines recent developments in the statistical balance sheets of credit institutions, looking specifically at developments in credit institutions' assets broken down by instrument and by counterpart sector.

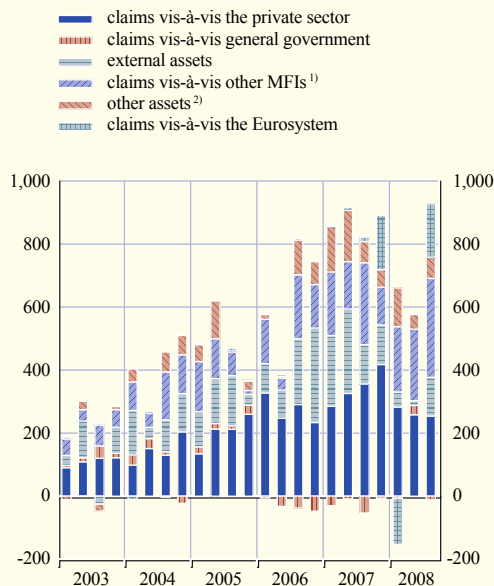
An aggregated view of the balance sheets of euro area credit institutions

The issue at hand requires that MFI balance sheet statistics be examined from a perspective that differs from that normally applied in monetary analysis. First, in order to assess the extent to which the pressures on credit institutions' capital and funding have had an impact on their balance sheets, it is necessary to look also at assets vis-à-vis other MFIs. These, however, are netted in the consolidated MFI balance sheet, which forms the basis for the monetary statistics, and the aggregated balance sheet therefore needs to be examined instead. Second, given that the ultimate objective is to map out the potential impact on firms and households' access to loans, the analysis is based on the balance sheets of credit institutions, rather than the MFI sector as a whole, thereby excluding both the money market fund sector and the Eurosystem. This breakdown of the MFI sector is available only on a quarterly basis.

¹ In principle, a number of strategies are available to credit institutions in order to restore the desired relationship between total assets and the capital base. In broad terms, these include a reduction in the total amount of assets held, an increase in the capital base, or a combination of the two. Capital can, in turn, be increased through capital injections and/or reductions in dividend payouts.

Chart A Credit institutions' asset holdings by sector

(quarterly flows; EUR billions; adjusted for seasonal effects)

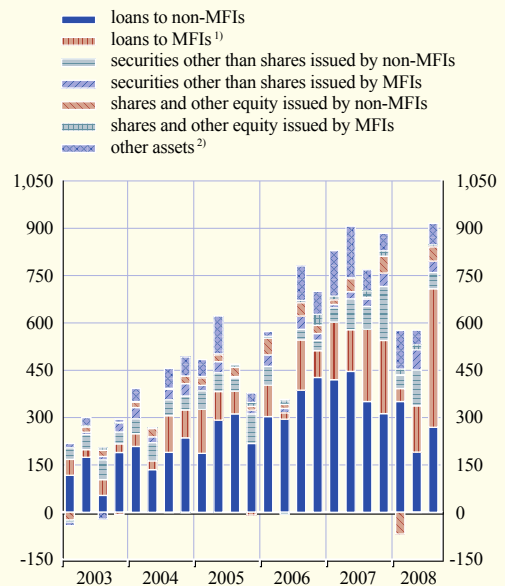


Source: ECB.

- 1) Claims vis-à-vis MFIs other than the Eurosystem.
- 2) "Other assets" comprise fixed assets, credit institutions' holdings of money market fund shares/units and the item "remaining assets".

Chart B Credit institutions' asset holdings by instrument

(quarterly flows; EUR billions; adjusted for seasonal effects)



Source: ECB.

- 1) Includes deposits vis-à-vis the Eurosystem.
- 2) "Other assets" comprise fixed assets, credit institutions' holdings of money market fund shares/units and the item "remaining assets".

Euro area credit institutions' total assets have continued to grow throughout the period of financial market tensions observed since the summer of 2007. Robust quarterly flows have been recorded, with the flow in the third quarter of 2008 being particularly large (see Chart A). However, these flows include large contributions from increased claims on the MFI sector itself, particularly in the fourth quarter of 2007 and the third quarter of 2008. To a large extent, this is due to increased claims on central banks, reflecting the extraordinary central bank operations undertaken by the Eurosystem. The growth of claims vis-à-vis the euro area private sector has been declining following its peak in the fourth quarter of 2007, but remains at a relatively robust level. Following the particularly large flows observed in late 2006 and early 2007, credit institutions have markedly scaled back their claims vis-à-vis non-euro area residents, reflecting, at least to some extent, the abandonment of investment strategies that have proved unprofitable following the onset of the financial market turmoil. Moreover, credit institutions appear to have reduced their exposure to government debt over the period of financial market tensions as a whole, potentially on account of investors' flight to safety boosting the value of such assets and thereby enabling credit institutions to realise substantial gains when disposing of them.

A breakdown of credit institutions' assets by instrument shows that loans continue to account for most of the growth in total assets. The financial market tensions initially had a positive impact on debt securities, with a particularly large quarterly flow being recorded in the fourth quarter of 2007 and smaller, albeit relatively strong, flows being observed in 2008 (see Chart B). To a large extent, this reflects the transformation into securities of parts of the loan portfolios of

some credit institutions, with these loans being securitised and the credit institutions retaining the resulting securities.

More recent, monthly developments

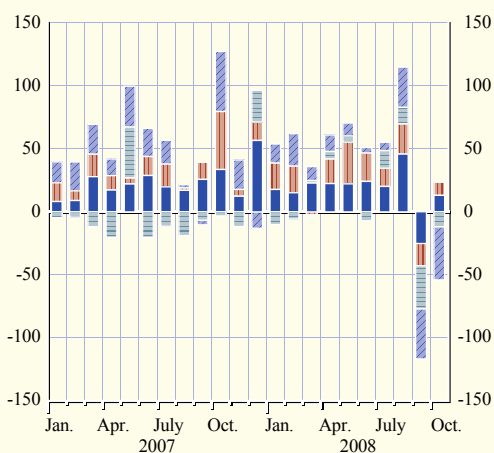
Given that the intensification of the financial market tensions triggered by the collapse of Lehman Brothers did not occur until mid-September, almost at the end of the third quarter of 2008, quarterly flows will dilute the effect of these recent developments. It is, therefore, useful to examine the recent monthly developments in the holdings of debt securities, although this is only possible for the MFI sector as a whole (see Chart C). This reveals a remarkable shedding of debt securities in September, across all types of issuer. The decline in the holdings of debt securities continued in October for those issued by non-euro area residents and the general government sector. At the same time, in October MFIs did acquire debt securities issued by other MFIs and the private sector. However, there are indications that this acquisition of private sector debt securities mainly reflected the continued securitisation of loans to the private sector, whereby the institutions originally holding the loans on their balance sheets also retained the resulting securities.

Developments in MFIs' holdings of debt securities in September and October therefore suggest that there are particular balance sheet items that have been quite markedly affected

Chart C MFIs' holdings of securities other than shares

(monthly flows; EUR billions; adjusted for seasonal effects)

- issued by the private sector
- issued by MFIs
- issued by general government
- issued by non-euro area residents

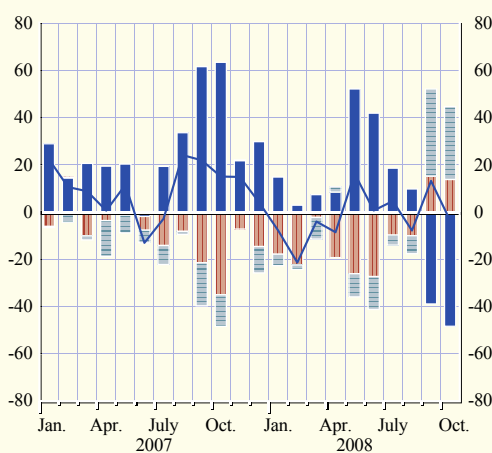


Source: ECB.

Chart D Issuance and holdings of MFI debt securities with a maturity of less than two years

(monthly flows; EUR billions; adjusted for seasonal effects)

- issuance of MFI short-term debt securities
- MFIs' holdings of MFI short-term debt securities (inverted)
- non-residents' holdings of MFI short-term debt securities (inverted)
- money-holding sectors' holdings of MFI short-term debt securities



Source: ECB.

Note: MFI short-term debt securities held by non-euro area residents and MFIs are shown with an inverted sign, as they are deducted from net issuance in order to calculate the money-holding sectors' holdings of these instruments.

by the intensification of the financial market tensions. A particularly interesting case in this respect is that of short-term debt securities issued by MFIs, where downsizing is observed not only on the asset side, but also on the liability side. In particular, net issuance of such instruments was negative in September and October, while at the same time MFIs reduced their holdings of these securities (see Chart D). Interestingly, this downsizing has affected mainly inter-MFI positions, as well as the holdings of non-euro area residents, whereas developments in the money-holding sectors' holdings of these securities have been relatively subdued.

Overall, developments thus far do not indicate a shrinking of the aggregated balance sheet of credit institutions in the euro area, although the rate of expansion of those credit institutions' total assets has moderated somewhat in recent quarters when their claims vis-à-vis MFIs are not taken into account. However, this does not rule out the possibility of individual credit institutions or a sub-set of the euro area credit institutions having reduced the size of their balance sheets in response to developments in financial markets since the summer of 2007. Moreover, it does not mean that there are no signs of downsizing for specific types of asset. Indeed, the data for September and October reveal that MFIs have reduced their debt securities portfolios, with their holdings of securities issued by the general government sector and non-euro area residents bearing the brunt of this adjustment. This development provides some tentative indications that credit institutions have been using their more liquid assets as buffers in order to absorb the pressures on their capital positions and funding, with a view to shielding their core, relationship-based business, namely the granting of loans to firms and households. However, more information is required before a conclusive assessment can be made regarding the capacity of these buffers to cushion the impact that developments in financial markets are having on the supply of financing to the private sector.