

Box 2

HOW ARE GOVERNMENT MEASURES TO SUPPORT THE FINANCIAL SYSTEM REFLECTED ON THE BALANCE SHEETS OF EURO AREA CREDIT INSTITUTIONS?

The extraordinary deterioration observed in global financial market conditions since mid-September 2008 has prompted governments and central banks across the globe to react with a range of equally extraordinary measures. This box adopts a specific perspective and examines the positions on euro area MFIs' statistical balance sheet in which such government measures are reflected. The measures introduced by the Eurosystem in order to ensure an adequate supply of liquidity to euro area credit institutions are not covered here.¹

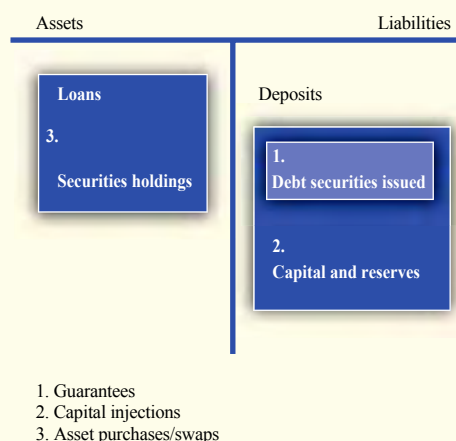
A simplified balance sheet for credit institutions

The examination of the MFI balance sheet is the starting point for the ECB's regular monetary analysis. Chart A contains a stylised representation of the balance sheet of credit institutions² showing the positions where the measures introduced are reflected. Euro area governments' initial reaction to the heightened tensions was to extend the scope of deposit guarantee schemes in order to bolster confidence in the banking system. This measure, however, was essentially preventive in nature, and so its impact is not directly observable on the balance sheet of credit institutions. The other measures introduced by euro area governments, which culminated in the announcement of the concerted European Action Plan on 12 October 2008, have a more directly discernable impact on both the liability side and the asset side of the balance sheet. These measures can be grouped into three broad categories: the introduction of

1 The ECB's liquidity management activities are regularly presented in the Monthly Bulletin. See, for instance, the box entitled "Liquidity conditions and monetary policy operations in the period from 12 November 2008 to 10 February 2009" in the March 2009 issue. For a discussion of the impact that the ECB's liquidity operations have had on monetary aggregates, see the box entitled "Recent liquidity operations and their impact on monetary aggregates" in the January 2008 issue of the Monthly Bulletin.

2 Credit institutions are the largest sub-component of the MFI sector, the other main sub-components being the Eurosystem and money market funds.

Chart A Stylised representation of the balance sheet of credit institutions and the positions affected by government measures



Source: ECB.

government guarantees covering debt securities issued by credit institutions (Measure 1 in Chart A), the injection of capital into credit institutions by government entities (Measure 2 in Chart A), and the purchase by governments of credit institutions' assets or the swapping of such assets for government securities (Measure 3 in Chart A).³ It should be recognised, however, that the measures implemented are in some cases complex and hybrid in nature and cannot therefore be easily classified under the scheme outlined above. In addition, in some cases the nature of the measures used implies that there is no direct impact on the statistical balance sheet of the credit institution involved (e.g. where governments provide protection against price fluctuations for assets held).

Issuance of MFI debt securities backed by government guarantees

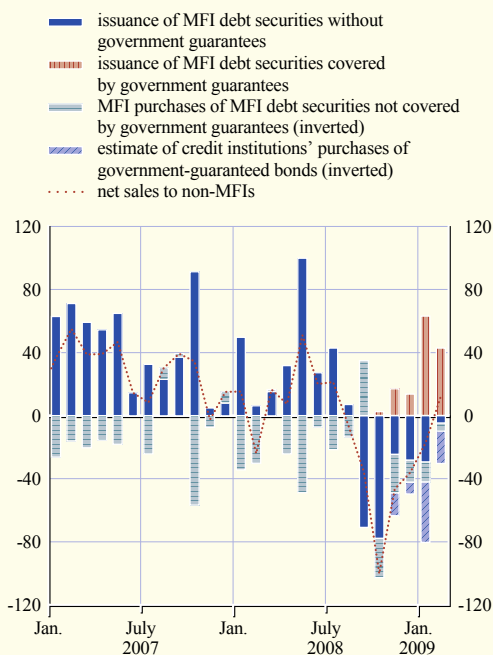
The guarantees provided by a number of euro area governments are intended to facilitate the funding of credit institutions. Such guarantees represent the most important type of measure from a quantitative perspective. Looking at the euro area as a whole, the maximum volume of debt securities that governments are committed to guaranteeing under such programmes amounts to 33% of all MFI debt securities issued.

Against the background of the tensions observed in important funding markets such as the market for unsecured bank bonds, the issuance of debt securities by euro area credit institutions (net of redemptions) was strongly negative in September and October 2008 (see Chart B). Since late 2008, following the implementation of the guarantee schemes, euro area banks have increasingly begun to issue debt securities under these programmes. In the period up to February 2009 the total nominal value of debt securities issued by euro area credit institutions under government guarantee programmes was approximately €140 billion. To a notable extent, these securities have been purchased by other credit institutions – a development recorded on the asset side of the banks' balance sheets – and have subsequently been used as collateral in Eurosystem operations. Euro area MFIs have also bought MFI debt securities not guaranteed by governments, and consolidating overall purchases with issuance implies that net sales of debt securities to non-MFIs (both resident and non-resident entities) were negative from September 2008 to January 2009. This development is recorded in the flows for the positions “Debt securities issued with a maturity of up to two years” and “Debt securities issued with a maturity of over two years” on

³ In addition to these measures, the European Commission has endorsed the amendments made to the International Financial Reporting Standards allowing securities to be reclassified and thereby moved out of those categories that require mark-to-market valuation and into categories where they are carried at amortised cost. For MFI balance sheet statistics, this measure could have the effect of inflating loan data at the expense of securities holdings, thereby introducing a reporting distortion. However, when calculating the respective flow series, such reclassifications are corrected for. Hence, the growth rates derived from these flows are not distorted. The respective stocks could potentially be affected, but for this to happen, the International Financial Reporting Standards would have to be used for statistical reporting, which is not the case in all euro area countries. In general, for statistical reporting, instruments are classified on an ex ante rather than an ex post basis (i.e. the negotiability of the security is not reassessed after issuance).

Chart B Issuance and net sales of MFI debt securities

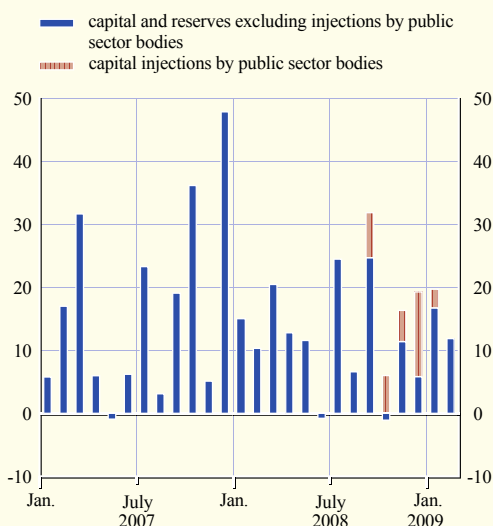
(monthly flows; EUR billions; not adjusted for seasonal or calendar effects)



Sources: ECB and ECB estimates.

Chart C Capital injections by public entities into euro area credit institutions

(monthly flows; EUR billions; not adjusted for seasonal or calendar effects)



Sources: ECB, Bloomberg and ECB calculations.

the consolidated MFI balance sheet and reflects the non-MFI sector's reduced funding of credit institutions through market sources.

Government capital injections

Euro area governments' provision of additional capital to financial institutions is intended to ensure that the proper financing of the euro area economy is not hindered by capital constraints. The recapitalisations implemented so far have taken different forms: either dilutive with regard to existing equity holders (i.e. involving the purchase of new common stock) or non-dilutive (comprising, for example, the purchase of new preference shares, or convertible or subordinated bonds). The MFI balance sheet statistics report governments' purchases of new shares as increases in capital and reserves, while governments' purchases of new bonds are reported as increases in the issuance of MFI debt securities.

The volume of injections committed to by governments for euro area financial institutions amounts to approximately 13% of euro area credit institutions' outstanding capital and reserves. Chart C illustrates the impact that this measure has on the monthly flow of capital and reserves by showing the gross amount disbursed to euro area credit institutions in a form affecting the capital and reserves position. For the period up to February 2009 such disbursements have a total value of approximately €35 billion. This amount is considerably smaller than the volume of recapitalisations or government commitments already announced. This discrepancy arises for several reasons. First, there is generally a lag – often of several months – between the announcement and the actual injection. Second, capital injections are not always entirely earmarked for banking operations, being directed, in some cases, at the insurance operations of financial conglomerates, and are thus not reflected on credit institutions' balance sheets. Third, some of the capital

injections are implemented using instruments that are reported as debt securities in the statistical framework, although from a regulatory perspective they qualify as capital. Chart C also shows that, up to the most recent month for which data are available, euro area credit institutions have been able to increase their capital and reserves over and above the capital injections received from governments, either by raising capital from non-banks or through continued profitability.

Asset swap and asset purchase programmes

The third type of measure comprises programmes involving outright purchases of high-quality assets from banks and the introduction of swap facilities allowing government bonds held by public authorities to be exchanged, on a temporary basis, for financial instruments held by banks. These measures therefore have a dual purpose: on the one hand, they provide credit institutions with liquid securities which can be used for funding purposes; and on the other hand, they potentially allow banks to alleviate their capital constraints by removing assets from their balance sheets. Of all the measures announced thus far by euro area governments, those that entail outright purchases or swaps of assets are the most limited from a quantitative perspective.

Governments' outright purchase of the assets of credit institutions would lead to a reduction in the securities or loans in the consolidated balance sheet of the MFI sector (see Chart A) and a commensurate decline in government deposits held with MFIs. By contrast, asset swap operations would, in principle, have no impact on balance sheet positions.

Conclusion

The broad range of measures introduced by euro area governments to support the financial system in response to the intensification of the financial turmoil is directly visible in a variety of MFI balance sheet positions, mainly on the liability side. Given the gradual implementation of these measures, ongoing monitoring of developments in the MFI balance sheet is necessary in order to assess the impact on the condition of euro area credit institutions and any ultimate effect on the flow of credit to the non-financial sectors. From a broader perspective, a monitoring exercise of this kind is essential if monetary analysis is to fulfil its role of extracting the signal from monetary developments that is relevant for the assessment of risks to price stability over the medium to longer term.