

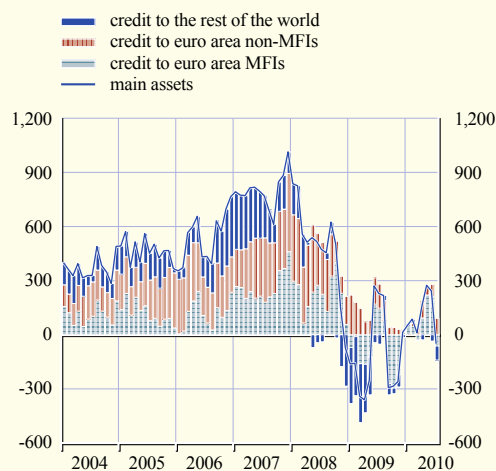
Box 2

THE ROLE OF INTER-MFI TRANSACTIONS IN RECENT MFI BALANCE SHEET DEVELOPMENTS

In response to the tensions in financial markets, but also the various policy and regulatory measures to counter them, the balance sheets of euro area MFIs have been undergoing a process of profound adjustment since late 2008. The MFI balance sheet statistics, which provide timely information for the monitoring of this process at the aggregate level, suggest that the adjustment has progressed in a staggered and volatile manner (see Chart A).¹ After an initial marked reduction in the size of their balance sheets in the aftermath of the collapse of Lehman Brothers, euro area MFIs have alternated between periods of accumulation and further shedding of assets. The main driver of this alternating pattern in balance sheet developments has been MFIs' holdings of assets issued by the euro area MFI sector itself (i.e. credit to euro area MFIs). This box examines developments in inter-MFI transactions over the period of MFI balance sheet adjustment.

Chart A MFI main assets

(three-month flows in EUR billions; adjusted for seasonal effects)



Sources: ECB, ECB calculations.

Notes: The reporting sector is MFIs excluding the Eurosystem. Credit includes holdings of loans, securities other than shares and shares and other equity. Main assets exclude the holdings of money market fund shares/units, fixed assets and remaining assets.

The role of claims vis-à-vis the Eurosystem and lending to other euro area MFIs

The most prominent type of inter-MFI transaction is the granting of loans. In the MFI balance sheet statistics, such loans also include euro area MFIs' claims vis-à-vis the Eurosystem central banks, which are statistically classified in the MFI sector. These claims mainly relate to credit institutions' current account balances with the Eurosystem and their recourse to the Eurosystem's

¹ The monthly MFI balance sheet statistics also include the assets held by euro area money market funds. However, the assets of these funds account for less than 5% of euro area MFIs' total assets.

deposit facility. In the context of the ECB's response to the financial crisis, these positions have become large, thus mirroring the provision of unlimited liquidity to euro area credit institutions by the Eurosystem. Therefore, they need to be identified separately.

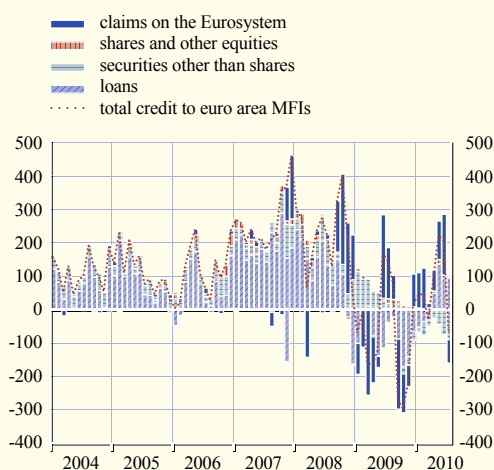
Lending to other euro area MFIs (i.e. MFIs excluding the Eurosystem) has been, together with holdings of assets vis-à-vis non-residents, the position that has borne the brunt of the balance sheet adjustment that euro area MFIs have undergone since late 2008. In some periods, however, the reduction in lending to other euro area MFIs has been more than offset by increased MFI claims vis-à-vis the Eurosystem. For instance, in the summer of 2009 the increase in MFIs' claims vis-à-vis the Eurosystem, following the large recourse to the first one-year longer-term refinancing operation in June, led to an expansion in the overall holdings of MFIs' assets (see Chart B).² Subsequently, and as credit institutions adjusted their borrowing from the Eurosystem, their claims were also reduced, contributing to the overall decline in credit to euro area MFIs in the fourth quarter of 2009 and imparting considerable volatility to this position.

In spring 2010 a renewed expansion of credit to euro area MFIs was observed. Claims vis-à-vis the Eurosystem again contributed to this increase. However, unlike during the short-lived episode in the summer of 2009, lending to other MFIs also contributed to this development. The evolution of this inter-MFI lending in 2010 has, however, been characterised by a "stop and go" pattern. In the light of the renewed tensions in financial markets that emerged during this period, it is unlikely that the spurts of increased inter-MFI lending observed are entirely indicative of a genuine improvement in the willingness of banks to lend to each other.

Initially, the increased inter-MFI lending in spring 2010 is likely to have reflected a gradual normalisation in euro area money markets. In this context, the Eurosystem had initiated the gradual phasing-out of some of its non-standard measures.³ Tensions in the sovereign debt markets, however, triggered renewed distrust among banks and eventually spilled over to the money market in late April. The large recourse to Eurosystem refinancing operations initially masked the impact of the renewed tensions in interbank transactions, as the redistribution of central bank liquidity among networks of affiliated credit institutions is likely to have supported a further increase in lending to other MFIs. In June, however, the continued tensions in financial markets, coupled with balance sheet adjustments related to the end of the quarter and some market participant uncertainty regarding liquidity conditions in view of the looming expiration

Chart B MFI assets vis-à-vis the euro area MFI sector

(three-month flows in EUR billions; adjusted for seasonal effects)



Sources: ECB, ECB calculations.
Note: The reporting sector is MFIs excluding the Eurosystem.

² See the box entitled "The impact of the first one-year longer-term refinancing operation" in the August 2009 issue of the Monthly Bulletin.

³ See the box entitled "Money markets' reaction to announcements regarding the phasing-out of non-standard measures" in the April 2010 issue of the Monthly Bulletin.

of the large one-year longer-term refinancing operation on 1 July, resulted in a retrenchment in interbank lending. Following the end of the quarter, and as market conditions improved in July, MFIs appear to have started increasing their lending to at least a sub-set of euro area banks. Nevertheless, total credit to euro area MFIs was reduced in July, as recourse to the Eurosystem's deposit facility was scaled down markedly.

The role of the residency of the counterparties to inter-MFI lending

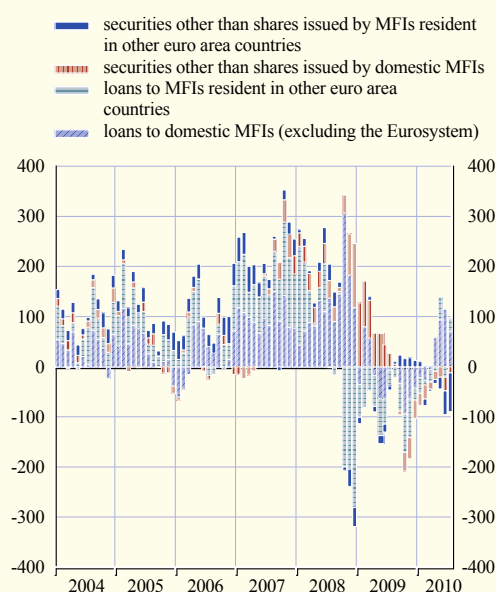
Tensions in financial markets have affected euro area MFIs' lending to other MFIs asymmetrically as regards the residency of the counterparty (recipient) MFI. Following the collapse of Lehman Brothers, euro area MFIs reduced their loans to MFIs in other euro area countries sharply, and, at the same time, increased their lending to MFIs in the country where they were resident (see Chart C). To some extent, this development reflects the restructuring of a large euro area banking group, which resulted in the unwinding of cross-border intragroup claims. It should be borne in mind that loans to MFIs reported in MFI balance sheet statistics also include claims that do not result from genuine market-based interbank transactions. For instance, they include transactions within banking groups.

As a result, operations such as restructurings can have a marked impact on these statistics. However, even discounting for the impact of this restructuring operation, the pattern of opposite developments in lending to domestic MFIs and MFIs resident in other euro area countries in late 2008 and early 2009 remains intact. This pattern suggests that the integration of euro area money markets, which was well advanced prior to the onset of the financial market turmoil, has been challenged, at least temporarily, as banks seem to have preferred to confine their interbank lending to within their own national borders.⁴ After this initial reaction, euro area MFIs eventually also reduced their loans to domestic banks.

A certain asymmetry, albeit less marked, has also been observed during the recent reinitiation of lending to euro area MFIs. In the first instance, this renewed lending was mainly directed towards MFIs resident in the same Member State as the lenders. Subsequently, however, lending to MFIs resident in other euro area countries has also picked up, with the exception of the development in June.

Chart C MFI assets vis-à-vis domestic MFIs and MFIs resident in other euro area countries

(three-month flows in EUR billions; adjusted for seasonal effects)



Sources: ECB, ECB calculations.

Notes: The reporting sector is MFIs excluding the Eurosystem. Loans to the Eurosystem and holdings of shares and other equity are excluded.

4 Evidence corroborating the retrenchment in cross-border interbank lending within the euro area at the aggregate level is also provided in Avdjiev, S., Upper, C. and von Kleist, K., "Highlights of international banking and financial market activity", *Quarterly Review*, BIS, Basel, June 2010. At the micro level, evidence is provided in Cassola, N., Holthausen, C. and Lo Duca, M., "The 2007/2009 turmoil: a challenge for the integration of the euro area money market?", a paper presented at the ECB-European Commission conference on "Financial integration and stability: the legacy of the crisis", Frankfurt am Main, 12 April 2010.

The role of holdings of securities other than shares issued by euro area MFIs

Besides outright loans, MFIs extend credit to other MFIs mainly by acquiring debt securities (securities other than shares) that these have issued. In the aftermath of the collapse of Lehman Brothers and while interbank lending was being reduced markedly, MFIs increased, quite substantially, their holdings of such securities (see Chart B). This largely reflects the relative attractiveness of these securities, by comparison with outright lending, in an environment of uncertainty regarding the balance sheet strength of at least part of the MFI sector. This attractiveness stemmed from the government guarantees covering most of the MFI debt securities issued during that period. As in the case of lending to MFIs, there is evidence of a “home bias” in the MFI debt securities acquired during this period. The securities purchased in late 2008 and the first half of 2009 had been issued by MFIs resident in the same euro area country as the purchaser, while holdings of debt securities issued by MFIs resident in other euro area countries were being reduced (see Chart C).⁵

Issuance of MFI debt securities covered by government guarantees has slowed down since the summer of 2009.⁶ At the same time, MFIs have largely refrained from purchasing further MFI debt securities and indeed have scaled back their holdings of such securities in recent months. This reduction has mainly affected their holdings of debt securities issued by MFIs resident in other euro area countries.

Conclusion

The staggered manner in which the adjustment of the balance sheet of euro area MFIs has proceeded since late 2008 has mainly reflected developments in credit to euro area MFIs. After a marked contraction in early 2009 the balance sheet of euro area MFIs has featured two main episodes of expansion. The first episode during the summer of 2009 was entirely driven by an increase in MFIs’ claims vis-à-vis the Eurosystem. In early spring 2010, however, increased inter-MFI lending also contributed to the accumulation of MFI assets.

For the efficient operation of the banking system, the distribution of surplus funds through the interbank market is required. In the face of dislocated money markets, the Eurosystem has temporarily assumed the role of providing this intermediation. The nascent revival of interbank lending activity in spring 2010 was interrupted by the renewed tensions in the financial markets. The coming months will clarify whether the resumption of inter-MFI lending in July reported in the MFI balance sheet statistics heralds a more sustained return to normality in the attitude of euro area MFIs towards lending to each other.

⁵ In some cases, the government-guaranteed debt securities issued were retained by the issuing MFI in order to be used as collateral in Eurosystem refinancing operations. Depending on the statistical treatment of asset and liability netting in the respective euro area countries, such operations have affected MFIs’ holdings of debt securities issued by domestic MFIs.

⁶ See the box entitled “The funding of euro area MFIs through the issuance of debt securities” in the August 2010 issue of the Monthly Bulletin.