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Delegations will find attached document COM(2016) 455 final.

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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND  
THE COUNCIL**

**on the use and benefits of longer-term refinancing operations and similar funding  
support measures provided by ESCB central banks to credit institutions**

## INTRODUCTION

In accordance with Article 161(9) of Directive 2013/36/EU (“CRD”) and after consulting the ECB, the European Commission has prepared this report to the European Parliament and Council on the use and benefits of longer-term refinancing operations and similar funding support measures provided by ESCB central banks to credit institutions. This report takes into account the report which the European Banking Authority (EBA) submitted to the European Commission on 17 July 2014<sup>1</sup>. This report must not be understood as opining on the exercise of the ECB'S and other Central Banks' monetary policy competences. In line with the mandate in the CRD this report assesses the use banks have made of past central bank funding support measures between 2011 and 2013 but does not assess the appropriateness of monetary policy operations.

The European Parliament and Council requested the Commission to report on the use and benefits of refinancing and funding support measures provided by several ESCB central banks to credit institutions between end 2011 and end 2013. Whereas the central bank funding operations were expected to have a positive impact on the real economy as a whole through increased lending to corporates and households, it was also argued that credit institutions could have benefited from this funding support to engage in other profitable transactions not related to household and corporate lending. In their mandate the co-legislators also invited the Commission to submit legislative proposals, if appropriate. These proposals would be aimed at limiting the possible opportunistic use of central banks' funding support measures by credit institutions.

## NATURE OF THE LONGER-TERM REFINANCING OPERATIONS

The longer-term refinancing operations and similar central bank funding support measures assessed by the Commission in this report are refinancing operations with low rates of interest and exceptionally long maturities entailing generally the acceptance of a wider range of eligible collateral. The context of these measures was severe stress on bank funding markets in Europe at that time. Several banks, particularly in more vulnerable countries, were experiencing serious liquidity problems, as a combination of significantly impaired access to the wholesale funding market and outflows from retail deposits. This translated into high funding costs, high loan-to-deposit ratios and elevated liquidity risk. Against this background, the aim of these operations was to provide long-term funding to euro area banks. It seems very likely that without longer term funding support banks in more vulnerable countries would have been forced to de-leverage at a higher pace. The long-term funding support measures were defined by EBA and the Commission as funding provided to banks directly via ESCB central banks with an initial or planned maturity of more than 1 year.

Four long-term funding support measures have been analysed (see also Table 1):

1. (Two) 3-year long-term refinancing operations (LTRO) by the European Central Bank;
2. Denmark's National Bank's 3-year loan facilities;
3. The Hungarian Central Bank's 2-year variable rate collateralised loans and;
4. The 'Funding for Lending Scheme' by the Bank of England.

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<sup>1</sup> <https://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-07+-+Central+banks+funding+support+measures.pdf>

In total the ESCB central banks granted approximately the equivalent of EUR 1,080 billion of funding between December 2011 and December 2013. The two ECB 3-year LTROs in December 2011 and March 2012 represented more than 95%<sup>2</sup> of the total longer-term refinancing measures in this period.

Table 1: Long term funding support measures – granted and paid back as at end 2013

<b>Long term funding support measures</b>	<b>Granted amount</b>	<b>% GDP 2011</b>	<b>Paid back amount</b>	<b>Outstanding amount (end 2013)</b>
ECB's longer term 3-year refinancing operations	EUR 1,018bn	11%	EUR 446bn	EUR 572bn
Denmark's National bank 3-year loan facilities	DKK 60bn (EUR 7bn)	3%	DKK 46bn (EUR 6bn)	DKK 10bn (EUR 1.3bn)
Hungarian Central Bank's 2-year variable rate collateralized loans	HUF 122bn (0.43bn)	<1%	HUF 10bn (EUR 0.04bn)	HUF 112bn (EUR 0.39bn)
United Kingdom's Funding Lending Scheme	GBP 44bn (EUR 53bn)	3%	GBP 2bn (EUR 2.5bn)	GBP 42bn (EUR 51bn)
<b>Total</b>	EUR 1,080bn		EUR 455bn	EUR 625bn

*Source: EBA report and Commission calculations*

#### **METHODOLOGICAL CONSTRAINTS TO ANALYSIS OF USES AND BENEFITS**

The analysis of the use and benefits of funding support measures provided by central banks encounters a methodological problem, due to the "fungibility" of funding. This "fungibility" problem relates to the fact that it is not possible to "track the money" borrowed by banks from central banks to its ultimate use. The borrowed funding is not earmarked for any specific purpose but is used interchangeably with other sources of funding to support a range of activities. EBA explained in its report that the "fungibility" problem precluded a precise quantification of the use and benefits of the central banks' funding. To circumvent this issue, EBA adopted a qualitative approach based on questionnaires addressed to the relevant central banks and supervisors. Although this method has its merits, unfortunately it does not allow robust conclusions to be drawn on the use and benefits of these long-term refinancing operations.

In order to overcome this "fungibility" constraint, the Commission attempted to develop a more quantitative analysis of changes in the balance sheets of national banking systems during the period when funding support was provided. However, this proved unsuccessful in delivering more detailed reliable insights into the actual use of the LTRO funding support measures by banks in the Eurozone.

During the period of the LTRO funding support measures there was on aggregate a slight deleveraging of the Euro area banking system of EUR 568 billion (with equally shares of deleveraging of banks' sovereign debt holdings and corporate lending of approximately EUR 250 billion each) on a total of Euro area balance sheet of approximately 33.000 billion (1.7%).

So whilst the approach identified variations in the asset and liability side of the aggregate balance sheet of national banking systems, it only permits the drawing of limited conclusions. This is particularly the case because it is not known how credit institutions would have behaved without recourse to longer-term central bank refinancing facilities. In short, there is no reliable

<sup>2</sup> As measured by overall gross amount granted

counterfactual as to how banks would have acted in the absence of these measures. The approach followed therefore cannot provide an overall appraisal of the use and effectiveness of the LTRO support measures. The Bank of England, for example, judged that at the outset of the "Funding for Lending Scheme", the situation was such that lending was more likely to decrease than increase, but without any great certainty<sup>3</sup>.

### **THE BENEFITS OF LONGER-TERM REFINANCING OPERATIONS FOR BANKS**

The European Parliament and Council mandate also asks whether and how ESCB central bank longer-term refinancing operations have led to benefits for banks. Leaving aside the advantage for banks arising from increased liquidity leading to lower yields on newly-issued bonds, the question of the benefits of the long term support measures depends on the use to which these funds are put by banks. As already pointed out in terms of the likely benefits for the real economy, it is impossible to draw definitive conclusions on the use of such funds in the absence of a reliable counterfactual. Consequently, the extent to which central bank refinancing operations have been used by banks to engage in "carry-trades" (i.e. using low-cost funding available through these refinancing operations to purchase higher-yielding sovereign debt) cannot be ascertained.

Nevertheless, some benefits of longer-term refinancing operations can be roughly estimated in terms of funding spreads, for instance, by comparing the funding cost of support measures (e.g. 1% p.a. for the 3-year LTROs) with the yield on the bank's debt securities during the LTRO funding. However, it is not possible to estimate the overall profit from carry-trade operations as, once again, it is not possible to determine precisely the amount of funds from the longer-term refinancing operations that has been used to finance carry-trades. It should also be noted that these carry trades were not risk-free operations, as sovereign default was at least for some time a contingency with a non-zero probability.

In order to maximise the allocation of funding to specific "uses" and avoid the "fungibility" problem, the Hungarian Central Bank and the Bank of England have implemented support measures whose characteristics were individualised and depended on the lending behaviour of a credit institution. In particular, the UK "Funding for Lending Scheme" was designed to encourage lending to the non-finance sector of the economy by linking both the price and quantity of long-term cheap funding to bank performance in lending to this sector of the economy. Participating banks and building societies were able to borrow up to 5% of the stock of their existing lending to the non-finance sector of the economy. This could be topped up by the amount of the net expansion of lending during a reference period (from end-June 2012 to end-December 2013). Furthermore, the price of funding under the "Funding for Lending Scheme" (FLS) varied as a function of the net lending by each beneficiary bank (as compared to end-June 2012) so as to encourage banks to lend to the non-finance sector of the economy. For banks that expanded their net lending as compared to end-June 2012, all borrowing from the FLS was at the lowest available rate of 25 bps per year. Conversely, banks that reduced their stock of loans had to pay an additional 25bps for each percentage point fall in their lending up to a maximum of 150bps. This system of incentives is likely to increase the probability that the funds borrowed from central banks benefit lending to the wider economy.

Similarly, the ECB quarterly TLTROs (Targeted Longer Term Refinancing Operations) which is not assessed here and which was available from September 2014 onwards<sup>4</sup>, use similar techniques to link the volume of borrowing to the volume of lending to the non-finance sector of

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<sup>3</sup> EBA's report (p. 22)

<sup>4</sup> Quarterly TLTROs will be conducted from September 2014 to June 2016

the economy<sup>5</sup>. In contrast, the two 3-year LTROs – with a fixed rate of 1% – did not have specific incentives or mechanisms linking central bank funding with bank lending to the corporate, SME and household private sectors.

## CONCLUSION

Article 161(9) of the CRD invites the Commission to submit, together with this report on the use and benefits of longer-term refinancing operations and similar funding support measures provided by ESCB central banks to credit institutions, a legislative proposal, if appropriate effectively curbing the possible opportunistic use of central bank liquidity support measures by banks. However, the theoretical and practical limits posed by the "fungibility" of funding sources does not allow a reliable identification of the use of ESCB funding support measures by banks. This renders it impossible to identify and quantify with any degree of confidence the profits attributable to possible opportunistic behaviour by credit institutions facilitated by such funding support. In conclusion there is no sound empirical basis to justify a legislative proposal from the Commission to the European Parliament and Council on this subject. Finally, the Commission notes and indeed welcomes the fact that the more recent ECB Targeted LTRO program provides incentives for banks to lend to the non-financial private sector.

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<sup>5</sup> For the first two operations, banks were thus allowed borrow up to 7 per cent of their portfolio of loans to the non-financial private sector (excluding loans for house purchase)