Europe
Special Report

The Role of the ECB — Temporary Prop or Structural Underpinning?

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Related Research

- *The Role of the ECB: Impact of Increased Liquidity on European Financial Markets and Banks (May 2008)*
- *Improving Bank Liquidity Standards (May 2010)*
- *Fund for Orderly Bank Restructuring — Spain (July 2009)*
- *Fitch Comments on EU/ECB/IMF Financial Package (May 2010)*
- *Euro-Zone Contagion: Common Challenges and Fundamental Differences (May 2010)*

Summary

Additional liquidity provided by the European Central Bank (ECB) since 2007 was successful in restoring confidence in the financial markets at the height of the economic crisis which began in August 2007. In Fitch Ratings' opinion, the ECB has safeguarded the financial stability of the euro zone banks throughout the crisis. The agency believes that the ECB will continue to reassure and support and, most importantly, work to restore confidence to the markets in terms of liquidity provision, as and when required.

However, the non-standard liquidity measures provided in the wake of the financial crisis were never intended to be permanent, as prolonged use would encourage additional risk-taking and lead to competition distortion and the postponement of necessary balance sheet adjustments. As the majority of European banks started to improve their financial position, the ECB announced that its liquidity support would gradually be withdrawn over the course of 2010 and 2011. Current events, however, particularly in Greece but possibly also in other southern European countries, have resulted in an extension of the non-standard measures and postponed the timing for their normalisation by at least another six months.

Fitch believes banks have generally taken the opportunity to restructure their balance sheets and to implement more rigorous liquidity management procedures during this exceptional period. However, when the ECB's support is fully normalised, the inadequacy of some banks' liquidity management policies may become more apparent-, particularly when liquidity buffers have been restructured to include structured finance (SF) assets eligible for refinancing with the ECB. European banks rely on the fact that the ECB, together with national central banks, currently allocate the full amount being bid by banks in their tender operations in exchange for liquidity at a fixed rate. However, at some point, the amounts allocated by the ECB are expected to be reduced to reflect monetary policy. Banks may not receive the allocations they require, nor will there be any assurances about how the allocations will be made.

Despite their efforts, European banks continue to be challenged with respect to long-term funding, particularly as government-guaranteed programmes are to be gradually phased out during 2010. Furthermore, there is some evidence to indicate that some banks are now relying on (short-term) ECB funds to meet structural funding needs rather than just for arbitrage opportunities. Therefore, a restriction on the amounts provided by the ECB will put pressure on the weaker players, most notably in the form of increased funding costs. A more detailed analysis of banks' funding profiles will be addressed in Fitch's forthcoming paper on European bank funding, due to be published in May 2010.

The ECB has also sought to increase investor confidence in the covered bonds market through its covered bond purchase programme launched in July 2009 (with a ceiling of EUR60bn — a relatively low amount compared with total covered bonds outstandings estimated at EUR2.4trn). The success of this policy in stabilising financial institutions' funding costs is undisputed. However, the effectiveness of the programme in channelling funds to the real economy is still difficult to ascertain, given the banks' tendency to hoard liquidity.

Pressures remain in the SF markets, however. The funding gap created by the closure of the SF markets in 2007 was bridged by significantly increased use of SF

securities by banks as collateral for shorter term repo funding with the ECB. In addition, European banks have chosen to structure self-retained SF transactions so that they are readily available for use as collateral to obtain liquidity should the need arise. However, given the desire to better manage the credit quality of SF collateral delivered to the ECB, it has imposed restrictions to its eligibility criteria for SF collateral, such that SF collateral is unlikely to grow significantly as a source of liquidity beyond collateral already within the system.

A delay in the return of funding sources to previous levels can also be attributed to a lack of transparency, including the clear disclosure of the use of ECB facilities by individual banks and the type of collateral presented by these banks, which continues to concern investors, particularly because of the continuing presence of a number of weak banks in the system. Market recovery may be stalled by such a perceived lack of clarity.

The availability and usage of the ECB liquidity facilities by banks throughout the euro zone has been a key factor in sustaining banks' Long-Term and Short-Term IDRs. Had these facilities not been available, a greater number of banks would have seen downgrades in their IDRs or even failed. Nonetheless, further IDR and Individual Rating downgrades are possible at those banks with particularly weak franchises, as these are the most likely to suffer from a drop in profitability once the ECB facilities return to normal. Further rating downgrades over the next 6-12 months cannot be ruled out.

In its analysis, Fitch concludes with the opinion that the use of ECB facilities by banks in Greece, Ireland and, to a more limited extent, Spain and the Netherlands, has become more extensive than in previous years and for some banks, this indicates a reliance on these sources for structural funding needs or as a boost to flagging profitability. On the other hand, banks in Italy and France have reduced their usage compared with pre-crisis levels and in general, banks have not become reliance on these facilities for funding. In Germany and Belgium, banks have reduced their use of these refinancing operations as a proportion of the total but they continue to be heavy users overall compared with other countries. Problematic banks in these countries are undergoing a restructuring of their balance sheets, including the sale of assets, and banks whose funding models used to rely heavily on these facilities have been identified and their ratings downgraded appropriately.

- ECB liquidity policy response to the economic crisis can be divided into four phases in line with the development of the crisis
- Currently, all bids for liquidity are fully met for both long-term refinancing operations and short-term refinancing operations
- One-year operations are being phased out. One further six-month LTRO but then expected to stop
- Long-term outstandings at end-2009 totalled EUR670bn, compared with pre-crisis average levels of EUR120bn. This will have to be replaced with other long-term funds
- Expanded list of eligible assets allows debt rated at 'BBB-' to be presented as eligible collateral at least until January 2011. No rating floor for Greek government or government-guaranteed debt

Current ECB Liquidity Policy

The ECB's policy response to the crisis evolved as the crisis deepened between August 2007 and October 2008, easing somewhat between October 2008 and the beginning of 2010 and then dipping again in May 2010, following tensions in the wholesale markets resulting from problems in Greece and its possible contagion effect on southern European countries and banks.

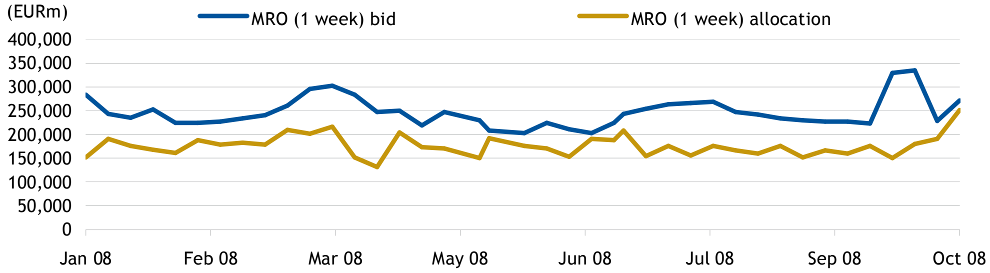
The ECB's response can be broken down into four distinct phases.

The first phase (August 2007-March 2008), was described in Fitch's Special Report entitled "*The Role of the ECB: Impact of Increased Liquidity on European Financial Markets and Banks*", which was published on 7 May 2008 (see *Related Research* link). In response to severe stress in liquidity, the ECB began to manage liquidity in the system more actively; it increased the amount of refinancing provided in longer term refinancing operations (LTROs) and increased its cooperation with other central banks. However, at the same time, it reduced the amounts allotted at the weekly main refinancing operations (MROs) in order to keep the total amount of outstanding liquidity constant. In other words, at the end of the first phase of the turmoil (March 2008), the relative importance of LTROs and of the shorter term MROs was inverted — MROs accounted for roughly EUR180bn versus EUR270bn for the longer term operations — but the overall supply of liquidity was not increased substantially. Therefore, at end-March 2008, ECB lending was still only funding approximately 2.1% of total euro zone consolidated banking system assets, compared with 2.3% at end-January 2006.

In the second phase of its response to the crisis (March 2008-September 2008), which started with the rescue of Bear Stearns by JP Morgan, the ECB reacted to a loss of market confidence in banks dependent on wholesale markets for funding. Together with the central banks of each eurosystem member country, the ECB intensified the provision of euro liquidity and expanded foreign exchange (FX) liquidity. It also continued to widen the maturity composition of its refinancing operations from weekly maturities to longer term maturities. Specifically, it increased the number of three-month variable rate tenders and introduced auctions with a six-month maturity. The proportion of longer term operations therefore continued to increase during the second phase, thus extending the overall average maturity of the refinancing operations. Nonetheless, at end-September 2008, not all demand for longer term funding was being fully met by the ECB (on average, during that period, allotted amounts equalled 67% of the initial bid amounts — see MRO and LTROs Bid/Allocation charts).

MROs Bid/Allocation

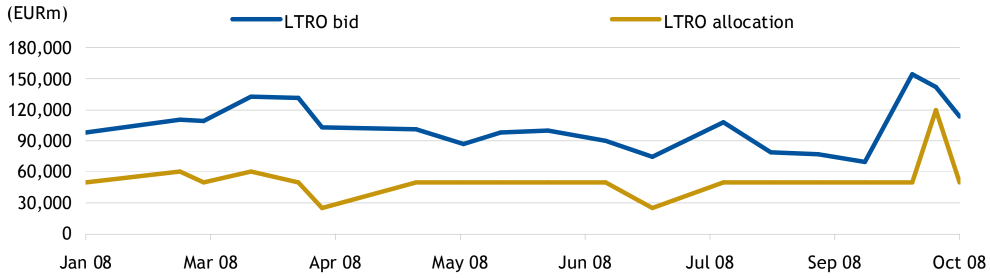
Second stage of the turmoil March 08-September 08



Source: ECB

LTROs Bid/Allocation

Second phase of the turmoil, March 08-September 08



Long-term operations include all maturities and currencies
Source: ECB

At end-September 2008, ECB lending was still only funding approximately 2.0% of total euro zone consolidated banking system assets.

The third phase followed the default of Lehman Brothers in Q308. At this point, the ECB began to supply liquidity in unlimited amounts (in other words, 100% of the bid amount was allocated to banks) at the policy rate both in euros and in FX (largely in US dollars and Swiss francs but also in other currencies). Swiss franc liquidity was discontinued in January 2010 because of improvements in markets and declining demand. US dollar liquidity was discontinued in February 2010.

At the same time, the ECB expanded its list of eligible assets to allow banks to refinance a larger share of their balance sheet with the ECB, thus allowing many

Breakdown of Eligible Collateral Presented to ECB — End-2009 (%)

Government debt	40
Bank bonds	20
Covered bank bonds	11
Asset-backed securities	10
Corporate bonds	10
Other bonds*	4
Other marketable and non-marketable assets	5
Total	**100**

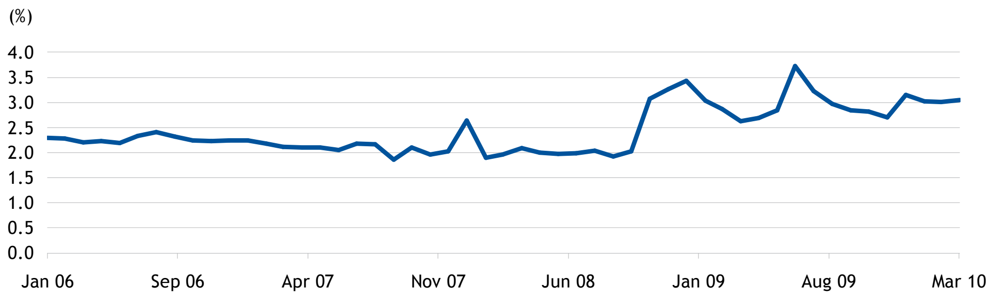
*eg those of supranational organisations

banks to protect their loan and securities portfolios from forced liquidation. It lowered the rating threshold for marketable and non-marketable assets to 'BBB-' and began accepting selected foreign-currency assets and securities issued in some non-regulated markets. As a result of the temporary measures to expand the list of eligible collateral, the overall volume of marketable assets amounted to around EUR1.4trn at end-2009 (11% of the total presented; source ECB annual report). By end-2009, the share of general government debt fell as a proportion of the total to account for just 40% at year-end (see the Breakdown of Eligible Collateral Presented to ECB — End-2009 (%) table), compared with about 50% at end-2006.

The ECB also supported banks by providing liquidity for longer periods. In June 2009, it conducted the first one-year refinancing operation. It allotted more than EUR440bn in this operation. A second operation, on 1 October 2009, supplied banks with EUR75bn, and in a third operation in December 2009, the ECB provided EUR96.9bn. These operations were made in addition to the regular and supplementary LTROs.

Total Open Market Operations Outstanding

As a percentage of consolidated banking system assets



Source: ECB

On 4 March 2010, the ECB announced that in view of economic and financial developments, it would continue to phase out its non-standard operational measures. 28 April 2010 signalled a return to variable rate tender procedures in the regular three-month LTROs. It also set down procedures to ensure the smoothing out of the liquidity effect of the 12-month LTRO maturing on 1 July 2010 (the due date of the first one-year LTRO). Its MROs will continue to be conducted as fixed-rate tender procedures with full allotment at least for the time being but for as long as necessary, confirmed by the ECB to be at least until 12 October 2010.

However, the ECB's plans to phase out its non-standard measures were superseded by tensions in the wholesale markets in May 2010, resulting from the problems experienced in Greece and the fourth phase of the ECB's liquidity response commenced. The ECB's initial reaction was a suspension of the minimum credit rating threshold in the collateral eligibility requirement for all securities issued or guaranteed by the Greek government for the foreseeable future. Then, on 10 May, it announced that it had decided to:

- reactivate the USD liquidity swap facilities following the re-emergence of strains in USD short-term funding markets in Europe. It also resumed USD weekly and three-monthly liquidity-providing operations from 11 May 2010. These are to take the form of repos against ECB-eligible collateral, at fixed rate with full allotment;
- continue with two additional fixed rate tender procedures with full allotment on the regular three-month LTROs (May 2010 and June 2010);
- conduct one further six-month LTRO with full allotment on 12 May 2010;

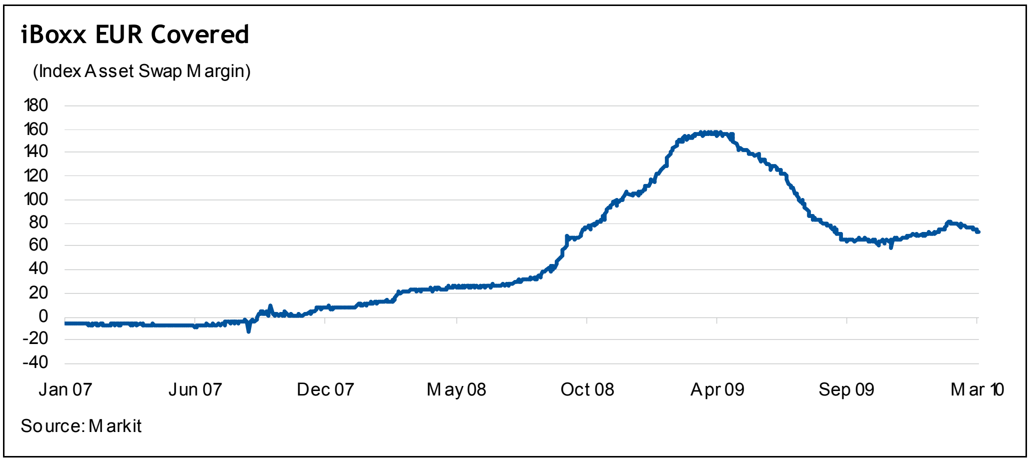
- purchase euro area public and private debt securities (Securities Markets Programme) to ensure liquidity in markets that have become "dysfunctional". The ECB Governing Council will determine the scale and scope of such interventions (see "*Fitch Comments on EU/ECB/IMF Financial Package*" and "*Euro-Zone Contagion: Common Challenges and Fundamental Differences*", both issued on 10 May 2010 — see *Related Research* links).

Impact of the ECB's Policy on the Covered Bonds Market

Covered bonds were already commonly used as collateral for repo operations with European central banks, and central banks often invest in covered bonds for the placement of their equity or, outside the euro zone, for the placement of their foreign-currency reserves. However, the announcement by the Governing Council of the ECB in May 2009 of an outright purchase of covered bonds fulfilled a different purpose: its aim was to contribute to a reduction in funding costs for credit institutions, to improve liquidity in the secondary markets and to promote the continued access of private individuals as well as companies to funding. The programme started in July 2009, with a ceiling of EUR60bn being made available until 30 June 2010.

The total amount was allocated between the ECB itself (8%) and the national central banks of the euro area in proportion of their participation in the ECB's paid-up capital — with the top four as follows: Deutsche Bundesbank (25%), Banque de France (18.7%), Banca d'Italia (16.5%) and Banco de Espana (10.9%). Covered bonds eligible to the scheme are denominated in euros, issued by entities incorporated in the euro area in a series of at least EUR500m (although issue sizes down to EUR100m can be considered on a case-by-case basis) and have a minimum rating of 'AA' by at least one rating agency. The text was carefully worded such as not to exclude covered bonds issued pursuant to contractual undertakings rather than under a dedicated legislation, provided the relevant national central banks consider them equally safe. Also, it did not differentiate between mortgage and public sector covered bonds.

This initiative was one of the most heavily scrutinised, as it was launched following months of reduced activity in the primary market (indeed, no jumbo covered bonds were issued at all in April 2009). The scheme could have easily backfired, as the total amount offered seemed unlikely to absorb the potential new supply and it took some time to organise practical implementation, with no details made public regarding the individual issues purchased and their actual purchase price. However, even before any covered bond was effectively acquired under this scheme, the announcement acted as a confidence booster for all market participants. Crucially, it removed a source of uncertainty for those covered bonds investors previously hurt by spread widening, as they had adopted a wait-and-see attitude in anticipation of further potential spread increases. Primary market issuance resumed and spreads tightened across all maturity ranges, and for all concerned jurisdictions.



The overall positive impact was also felt outside the euro zone, as Nordic covered bonds issuers benefited from the generally improved sentiment for their new and tap issues and UK issuers accessed the market for the first time since the start of the crisis.

The eurosystem's covered bonds purchase programme has been rolled out in a progressive manner, reaching an aggregate outstanding of EUR50.043bn at end-April 2010. Interestingly, the large majority (72%) has been bought on the secondary rather than the primary market. In order to address the risk that this buy-and-hold strategy could hamper the very same liquidity that the scheme intends to foster, the ECB Governing Council decided in March 2010 that the purchased bonds could be made available for lending to eligible counterparties through repurchase agreements.

As with all political decisions, some criticism was unavoidable: the domestic implementation, assuming a natural home bias of national central banks, meant that support was not necessarily directed at those which needed it the most. Also, there was some paradox in supporting an asset class which should in itself have fared better than others throughout the crisis. Yet the programme has been very successful in stabilising financial institutions' funding cost, and has gone far beyond the narrow scope of the total purchased amount. Secondary market liquidity is less tangible, and therefore harder to assess. Arguably, the drivers of liquidity in the covered bonds markets have changed since market makers would commit to fixed bid and re-offer spreads for benchmark issues, and an improvement in the post-crisis environment will require other measures, notably regarding secondary prices transparency.

The success of the programme's objective to channel funding to the private sector — rather than merely enable the banks to hoard liquidity — can probably only be judged in the months following the end of the purchase programme. So far, there has been no official indication that the programme may be renewed. In the absence of other exogenous shocks, for example regarding sovereign risk, the exit out of the purchase programme should not cause any withdrawal symptoms for the banks.

However, the covered bonds market dynamics could certainly be impacted by the Basel Committee's upcoming decision and the EU's directive on liquidity standards. The attractiveness of holding covered bonds over government bonds will be materially reduced, especially if the narrow definition of highly liquid assets prevails, which excludes covered bonds. Even under the broader definition, the haircuts applied to covered bonds holdings will act as a deterrent, and the eligibility criteria in terms of maximum bid-ask spread (50bp during the last 10 years or relevant period of significant stress) and maximum price decline (10% over a 30-day period during the last 10 years or relevant period of significant stress) may be hard to prove in individual cases.

The ECB Policy Impact on the Structured Finance Market

SF markets continue to be moribund globally since the onset of the credit market crisis in mid-2007, leaving banks with a funding gap for new loan growth, as well as liquidity issues when the SF market seized up. This gap was bridged by significantly increased use of SF securities by banks as collateral for shorter term repo funding with the ECB. As the ECB also expanded its liquidity operations, the use of SF securities for this purpose increased further. The ECB had always accepted SF securities as eligible collateral for its liquidity operations since the creation of the euro in 1999. However, given the lack of investor appetite for SF securities after mid-2007, the extent to which banks used SF collateral for this purpose rose dramatically.

Although Fitch is not aware of any publically-available detailed figures regarding the extent of SF collateral actually posted with the ECB, the proportion of ECB repo-eligible collateral consisting of SF securities rose from 4% in 2004 to 18% in 2007 and 28% in 2008. By end-2009, this had reduced to 23%, managed down through increased haircuts. However, in terms of average value of collateral, the euro amount increased from EUR442bn in 2008 to EUR468bn in 2009. The SF figures for 2009 would be higher still, but for the reclassification of Spanish multi-issuer cedulas from SF to covered bonds compared with earlier years.

Asset Class

	2009	2008	2007 post-crisis	2007 pre-crisis
Asset-backed securities	43.51	56.04	8.08	22.52
Commercial mortgage	5.98	1.19	5.20	23.89
Residential mortgage	155.82	345.03	108.93	111.10
SME CDOs	57.30	42.45	28.61	25.32
Total	**262.62**	**444.71**	**150.82**	**182.82**
Spanish RMBS	25.52	64.82	21.57	40.84
Dutch RMBS	39.52	69.88	68.00	36.79
Other RMBS	90.78	210.32	19.36	33.47
Total RMBS	**155.82**	**345.03**	**108.93**	**110.10**

[a] Table includes only euro zone countries. In particular, it excludes euro-denominated issuance from the UK which could be eligible for ECB funding
[b] Issuance includes all rated issuance. Only issuance rated 'A-' or above would actually be eligible for ECB funding
[c] 2007 pre-crisis = 1 January-31 August
[d] 2007 post-crisis = 1 September-31 December
Source: Fitch

Changes to Eligibility Criteria and Haircuts

In February 2009, the ECB introduced changes to the haircuts applied to SF securities when determining the extent of the advance rate against the value of the collateral (further information on this and on the expected impact of the ECB policy on the SF markets will be addressed in a Special Report to be published by Fitch in May 2010). All the cumulative moves have served either to reduce the amounts advanced against SF collateral, or to restrict the rating eligibility for repo funding.

The tightened eligibility criteria and increased haircuts are intended to re-balance the profile of collateral posted with the ECB, given that the proportion attributable to SF increased considerably since the onset of the credit crisis in 2007. In contrast, the portion attributable to government bonds has shrunk (correspondingly). The tightened eligibility criteria for SF runs counter to the temporary relaxation of minimum rating criteria for government bonds which has been removed in the wake of challenges for certain sovereigns within the euro zone, most notably Greece. Such changes may also be made with a view to restoring the relative balance of collateral types to a level more akin to that seen in the first half of the decade and more in line with market liquidity.

The ECB's final aim is to manage the extent of use of its facilities by banks, with a view to encouraging a tentative exit from the sizable exposure that the ECB now has to SF securities.

Country Profiles

The Outstanding Main and Longer Term Refinancing Operations in the Euro Zone (End-2009) table, together with the charts in the following pages, show that at end-December 2009, Germany continued to be the greatest user of the ECB liquidity facilities, although its usage of the facilities fell over the period 2007-2009 when compared with the size of its banking sector. The same can be said for Belgium, which, like Germany, has been a traditionally strong user of these facilities. On the other hand, Greece, Ireland, Spain and the Netherlands have increased their usage of the facilities when compared with the size of their banking systems. It should be noted that the table does not give any indication of the extent of “back-to-back” arrangements allowing banks in non-eurosystem countries (most notably the UK) to access ECB funds.

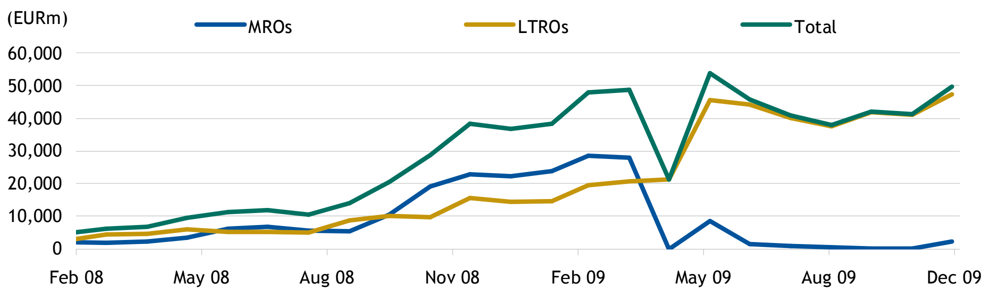
Outstanding Main and Longer-Term Refinancing Operations in the Euro Zone (End-2009)

(EURm)	MROs	LTROs[a]	Total outstanding	Total outstanding (%)	Total banking system assets (%)
Total eurosystem	79,293	666,297	748,590	100.0	100.0
Germany	22,700	171,100	193,800	25.89	23.87
France[b]	500	116,500	117,000	15.67	24.57
Italy	1,994	23,410	25,404	3.39	12.04
Spain	2,801	78,640	81,441	10.88	11.07
Netherlands[c]	60,963		60,963	8.14	7.11
Ireland	7,525	84,433	91,958	12.28	5.24
Belgium	5,002	36,275	41,277	5.51	3.72
Greece	2,355	47,300	49,655	6.63	1.58
Other[d]			86,792	11.59	10.8

[a] LTROs include all maturities
[b] French data refers to Jan 2010
[c] No maturity breakdown for the Netherlands
[d] Cyprus, Luxembourg, Malta, Austria, Portugal and Slovenia
Source: Fitch

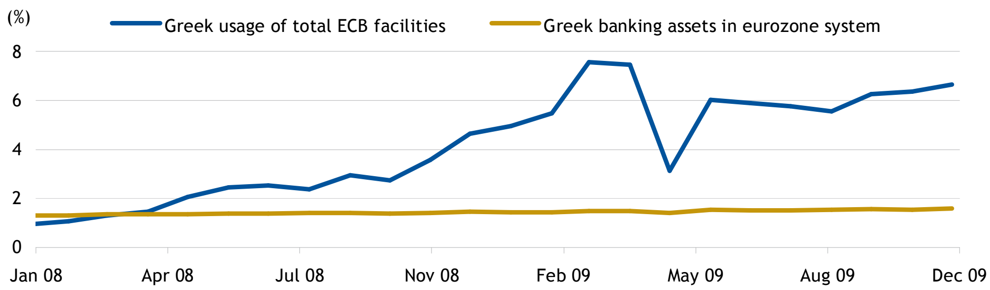
Greece

Greek Usage of ECB Facilities
2007-2010



Source: ECB, Bank of Greece

Greek Usage of Facilities
Compared to Greek banking assets



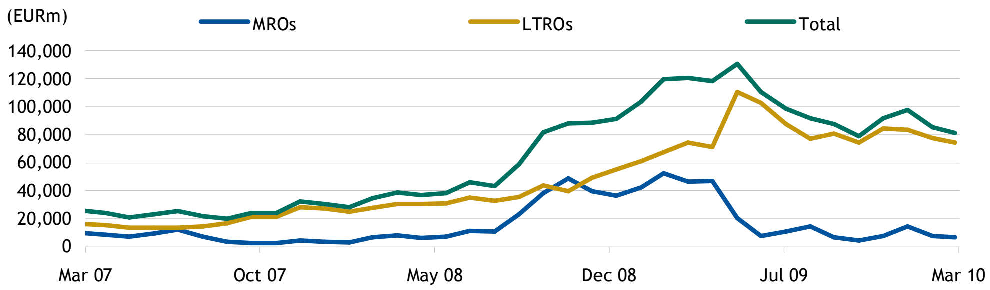
Source: ECB, Bank of Greece

Greek banks are now relying on the ECB liquidity facilities extensively and substantially more than their European peers are, and this is likely to remain the case in the short term. More recently, banks have increased usage of this facility further to boost short-term liquidity, to help refinance maturing debt and to mitigate the contraction of customer deposits. This effect results from the elevated risk perception surrounding the Greek sovereign and the banks, resulting in restricted access to wholesale and interbank markets. The major Greek banks have applied for a further allocation of their respective quotas under the Greek bank support scheme, notably for government guarantees on issued debt and special-purpose treasury bills to be used for ECB discounting. These measures, together with the banks' efforts to increase the amount of ECB-eligible assets by making certain rated corporate loans eligible and/or securitising assets to be retained on-balance sheet, will, in Fitch's view, increase the banks' liquidity buffer further, shielding them to some extent from the risk of potential further erosion in deposits.

Nonetheless, Fitch believes the banks will be challenged to maintain their current liquidity position, given the market volatility. On a positive note, as a result of the ECB's suspension of the application of the minimum credit rating threshold in the collateral eligibility requirements in the case of marketable debt instruments issued or guaranteed by the Greek government (not SF securities), a major source of liquid assets for Greek banks, is expected to remain eligible, easing the pressure on banks' liquidity profile, to some extent.

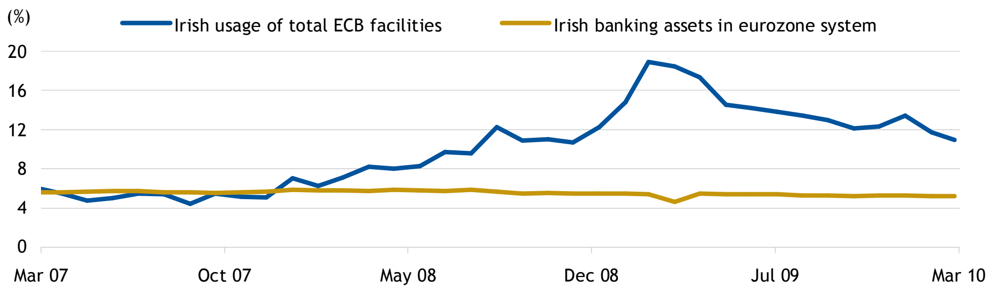
Ireland

Irish Usage of ECB Facilities
2007-2010



Source: ECB, Central Bank and Financial Services Authority of Ireland

Irish Bank Usage of ECB Liquidity Lines
Compared to total Irish banking system assets



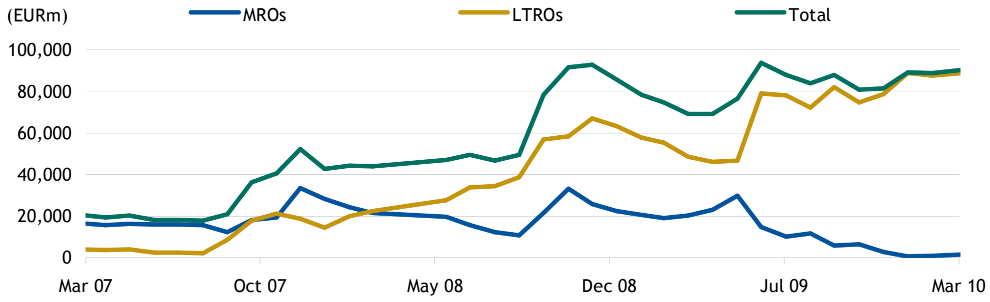
Source: ECB, Central Bank and Financial Services Authority of Ireland

Although usage of the ECB facilities by Irish banks increased during 2008 and 2009 from relatively low levels, the amounts borrowed declined by end-2009 and are expected to fall further in 2010 as access to the capital markets gradually improves and as Irish credit institutions make additional use of national schemes introduced to ease funding restrictions. These schemes include the sale of loans to the National Asset Management Agency (NAMA) in return for Irish government or government-guaranteed bonds and the Eligible Liabilities Guarantee (ELG) scheme, which allows banks selectively to request a guarantee for their funding. Although the NAMA scheme is ending in September 2010, the ELG scheme is to be reviewed by the European Commission in June 2010 and it is Fitch's expectation that if required it will continue to be extended to Irish banks.

The availability of this scheme, combined with the receipt of bonds from NAMA and the associated reduction in commercial real estate loans, will therefore take some pressure off banks' funding in the case of a restriction in the ECB's liquidity facilities. As the IDRs of Irish credit institutions are at their respective Support Rating Floors, Fitch dos not expect additional rating changes purely as a result of changes in the ECB's liquidity policies. However, a further restriction in the availability or an increase in the cost of funding, ECB or other, could lead Fitch to review Irish banks' already vulnerable Individual Ratings.

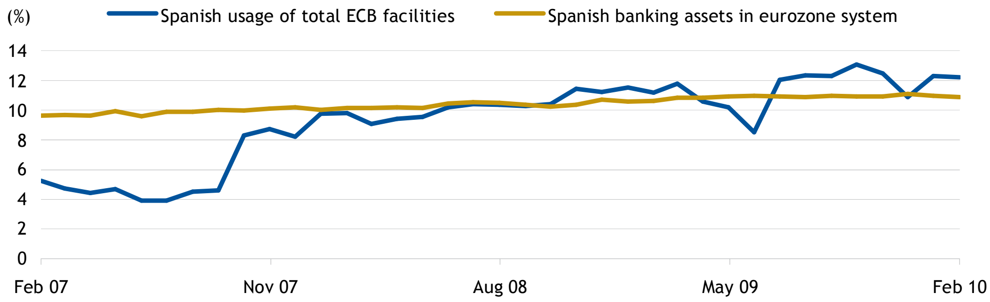
Spain

Spanish Usage of ECB Facilities
2007-2010



Source: ECB, Banco de Espana

Spanish Usage of ECB Facilities
Compared to Spanish banking system assets



Source: ECB, Banco de Espana

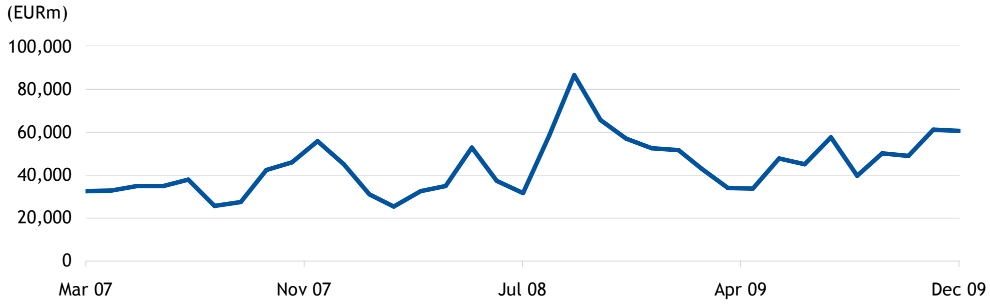
Spanish banks were affected by the closure of the securitisation market in 2007 as banks had begun to rely relatively heavily on this funding mechanism for their large and, at the time, growing mortgage portfolios, either through RMBS securitisations or multi-issuer covered bond securitisation programmes, the latter mostly used by the small and medium-sized banks and savings banks.

The large banks have issued covered bonds directly in the market. Banks have continued to securitise assets (Spanish banks have securitised, on aggregate, around EUR280bn in assets since August 2007), but have been keeping the structured securities on-balance-sheet, using them as eligible collateral in ECB repo operations. As a result, the usage of ECB facilities by Spanish banks increased both in absolute terms and in terms of overall funding, so that whereas previously the ECB liquidity facilities used by Spanish banks (taken as a proportion of the total made available to the euro zone) was low compared with Spanish banking system assets, now they are slightly higher. Given their past reliance on this source of funding, therefore, with the expected restriction in the availability of liquidity from the ECB at some point, combined with the expiry of government-guaranteed debt schemes in 2010, Spanish banks may find that their liquidity is affected. The immediate result is a potential increase in funding costs although this impact is not expected to be large enough on the bigger banks to warrant a change in their ratings as they are expected to be able to pass on this rise, at least partly, to their clients. It may, however, have a rating impact on the smaller banks with weaker franchises.

The large Spanish banks and medium-sized-to-large savings banks were able to access the wholesale markets in 2009 and Q110 by issuing senior debt and mortgage covered bonds and have not been reliant on ECB funds or government guaranteed debt issuance. The Fund for Orderly Bank Restructuring (see Fitch's "*Fund for Orderly Bank Restructuring — Spain*" Special Report, published on 3 July 2009 — see Related Research link), which was created in June 2009, is focused on consolidating the fragmented savings bank sector to create larger institutions and should facilitate access to wholesale markets. There are still uncertainties regarding the pace and final structure of this consolidation process. For these institutions, liquidity will be largely supported by balance sheet deleveraging with a greater focus on gaining customer deposits, while lending is expected to remain flat or decline.

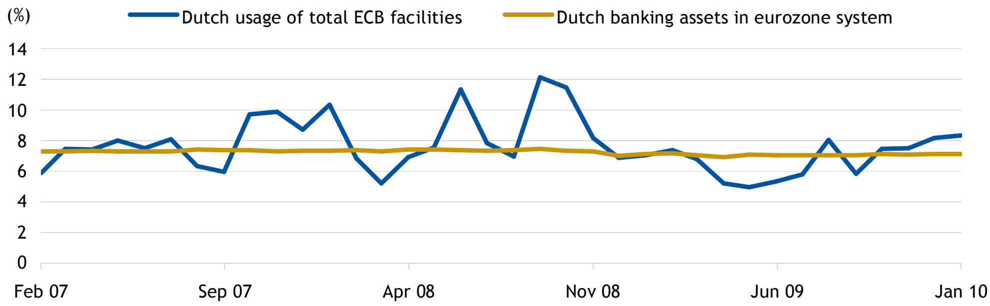
Netherlands

Dutch Banks' Usage of ECB Facilities
(Breakdown MRO/LTRO no available)



Source: ECB, De Nederlandsche Bank

Dutch Banks' Usage of ECB Facilities
Compared to Dutch banks' banking system assets

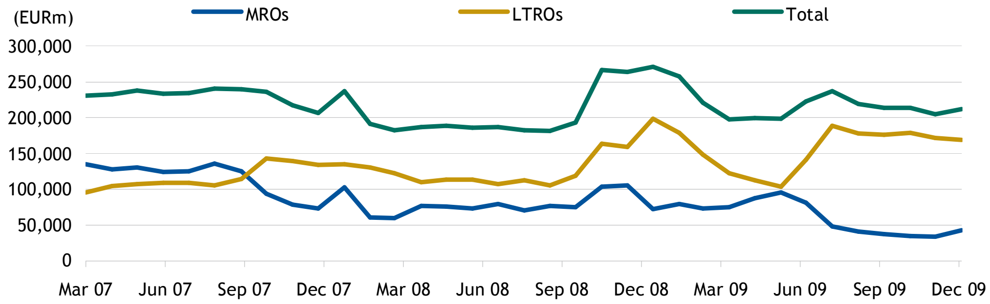


Source: ECB, De Nederlandsche Bank

A feature of Dutch banks' balance sheets is the significant portion of loans which exceed customer deposits (end-2009: the loan to deposit ratio of the Dutch banking system stood at 123% — source: De Nederlandsche Bank) and, similar to Spanish banks, the Dutch banks were affected by the sizing up of the securisation market in 2007 because of the large portion of their mortgage portfolios funded this way. Again, banks have continued to securitise assets and keep the structured securities on-balance-sheet, using them as eligible collateral in ECB repo operations (Dutch banks securitised EUR195bn in the period between mid-2007 and mid-2009 retaining most of these securitisations). Similar to Spanish banks, the expected restriction in the availability of liquidity from the ECB, combined with the expiry of government-guaranteed debt schemes in 2010, and, in the specific case of the Netherlands, the price war on deposits, may see a rise in funding costs for the banks. The rating impact of this effect is more likely to affect the smaller banks with weaker franchises.

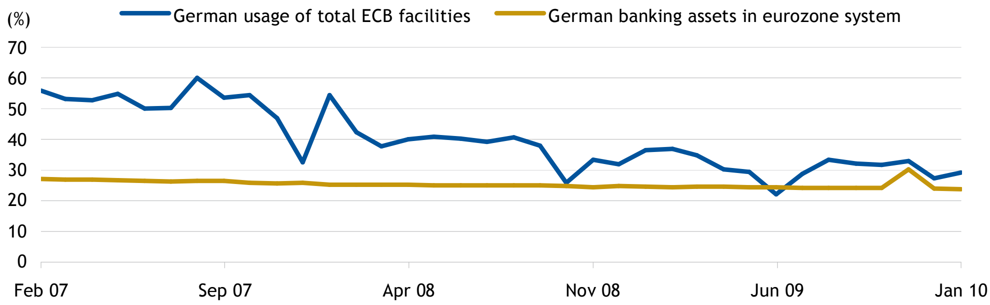
Germany

German Usage of ECB Facilities
2007-2010



Source: ECB, Deutsche Bundesbank

Germany Banks' Usage of ECB Liquidity
Compared to banking system assets



Source: ECB, Deutsche Bundesbank

German banks have traditionally been big users of ECB facilities. This stems from a number of large wholesale banks in the German market that use the ECB (and prior to that used the Deutsche Bundesbank) as a liquidity resource and provider of short-term funds at relatively favourable rates to finance their large bond holdings. The banks have always pledged a wide range of bonds, including Pfandbriefe, unsecured bank bonds, federal and state government securities, corporate bonds and, in more recent years, asset-backed securities. Although the ECB facilities continue to be used by German banks more extensively than banks in other countries, in contrast to many other European banking systems, the volumes of pledged securities have not increased during the crisis, so their relative important in the eurosystem has fallen.

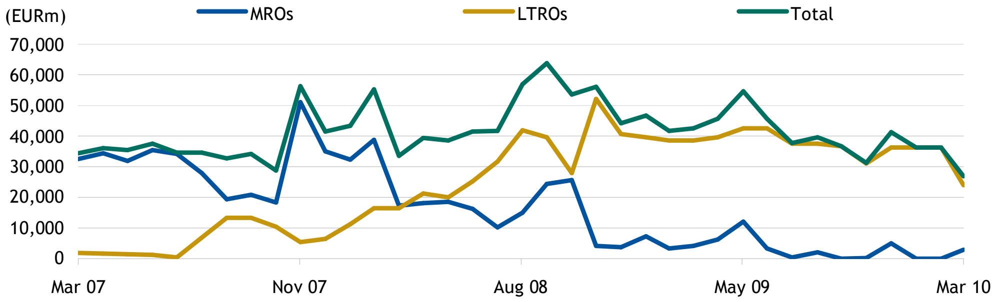
This can largely be explained by two developments. Firstly, the German Pfandbrief market remained open during the crisis, particularly for smaller tap issues, giving at least the Pfandbrief issuers an alternative option. Secondly, the banks that were previously aggressive users of the ECB funding were restructured extensively in 2007 and their balance sheets were reduced. The focus of many German wholesale banks during the past two to three years has been on restructuring their balance sheets, reducing particularly their problematic assets, so the loans/deposit ratios are improving, with covered bonds generally providing funding for the balance.

Increased competition for ECB funds now coming from banks in other countries will put some pressure on the traditional German wholesale baking model once the ECB reduces available securities and prices are driven up. However, the funding and liquidity needs of these banks are reducing as their balance sheets get smaller.

The concerns Fitch has about the viability of the business model on a smaller scale and with more expensive costs of wholesale funding have already been taken into account in the relatively low Individual Ratings for these banks, with IDRs based, in most cases, on state support.

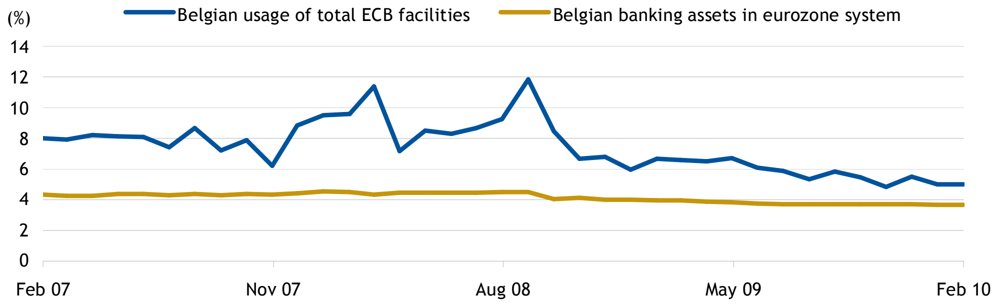
Belgium

Belgian Usage of ECB Facilities
2007-2010



Source: ECB, Banque National de Belgique/Nationale Bank van Belgie

Belgian Banks' Usage of ECB Facilities
Compared to Belgian banks' banking system assets

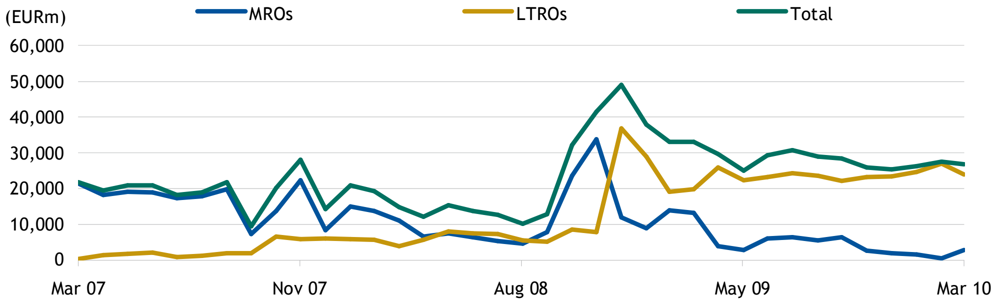


Source: ECB, Banque Nationale de Belgique/Nationale Bank van Belgie

Like German banks, Belgian banks' use of central bank lending facilities has always been high compared with the size of the banking system, owing to the significant amount of government bonds on banks' balance sheets available for use as collateral for repo transactions and the possibility of obtaining some additional interest margins by placing these bonds as collateral with the central bank. Belgian banks benefit from a large amount of deposits and have thus not relied on the SF markets to the extent of some of their European counterparts. Moreover, the loan to deposit ratio of Belgian banks has improved during the crisis as the loan book has declined, in line with lower credit demand. Belgian banks have not therefore increased significantly the use of these liquidity facilities during the crisis. However, there are some exceptions to the rule, with Dexia, in particular, relying on the ECB for funding. Changes to ECB rules are not expected to have a significant impact on Belgian banks in general.

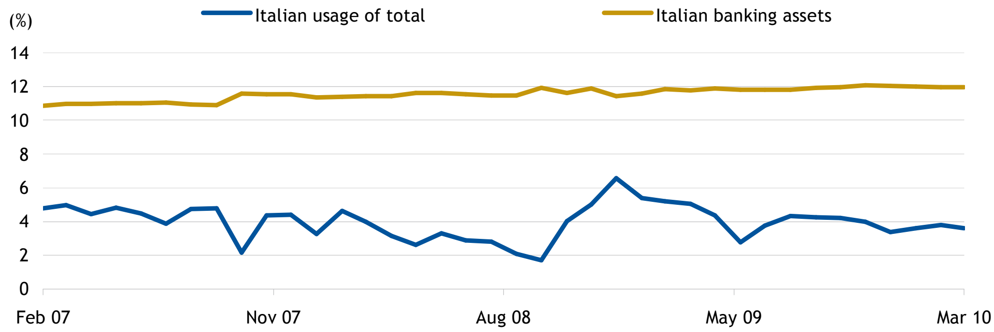
France and Italy

Italian Usage of ECB Facilities
2007-2010



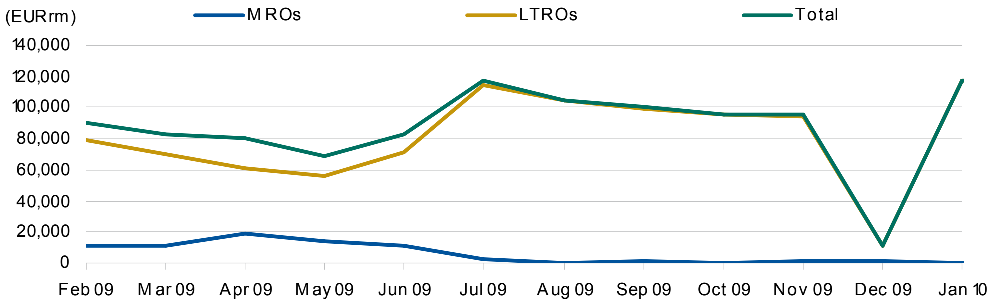
Source: ECB, Banca d'Italia

Italy



Source: ECB, Banca d'Italia

French Usage of ECB Facilities
2007-2010



Source: ECB, Banque de France

While French and Italian banks increased their usage of ECB funds through the crisis, particularly towards the later part of 2008, due to their generally broad and stable retail deposit bases, they were able to weather the turmoil of the wholesale markets relatively unscathed. Banks in these countries were able to access longer term debt on the financial markets in 2009 and 2010 and have made use of the long-term ECB funds mainly as a cheaper alternative to long-term debt, or, in some cases, to invest these cheap funds in higher yielding government bonds. The greatest impact of the scaling back of these facilities is likely to be on reduction in the net interest margin and negative pressure on profitability, although the impact is not expected to be large enough to result in a negative rating action.