

## Accountability and the ECB

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Since the financial crisis the Eurosystem (the ECB and the National Central Banks (NCBs) of the 16 Euro Area member states) have greatly expanded both the scope of their actions and the size of their balance sheets. NCBs have conducted lender-of-last resort actions for their governments' accounts. The ECB has massively expanded the range of securities that are acceptable as collateral in the repos and other collateralised loan transactions done by the NCBs. It has participated in currency swaps with other governments and provided repo facilities to non-Euro Area countries such as Hungary. On 9 May 2010, it announced that it would purchase Euro Area government bonds outright in secondary markets as part of the financial support scheme for heavily indebted Euro Area countries. In acting as a lender of last resort, or otherwise intervening in financial markets, the Eurosystem is taking on risk and redistributing income. Allowing an independent and unelected body to have such a political role is only palatable in a democracy if the institution is viewed as legitimate.

*The ECB must be transparent to ensure that it has legitimacy*

The ECB will be viewed as legitimate as long as the electorate believes that it has both the right to do the new tasks it has taken on and that it is the most appropriate institution to perform them. There are two related sources of such legitimacy: input legitimacy and output legitimacy. Input legitimacy can arise if the citizenry approve of the way that tasks were delegated to the ECB

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and if the ECB is accountable. Output legitimacy can occur if the ECB does its assigned tasks in a satisfactory manner and does not undertake tasks that it has not been assigned, even if it can do these tasks well.

Unfortunately, the Treaty, which gives the ECB some input legitimacy in its role as monetary policy maker, has little to say about a financial stability role, and what it does say is vague and ambiguous. In addition, the ECB's latest expansion of its powers, buying government debt outright in secondary markets – rather than directly in the primary issuer market – is widely seen as a flouting of the spirit of the Treaty. This action may have been necessary, but an unfortunate consequence is less output legitimacy. Thus, if the ECB is to have a hope of being perceived as legitimate, it must be seen as both competent and accountable.

The ECB has not existed for long enough to draw a firm conclusion about its competency, even in making monetary policy. Nevertheless, most economists would probably view the ECB's performance, both in ensuring price stability and in its financial stability role, at least since August 2007, as being as good as that of the world's other major central banks. Thus, the ECB has some output legitimacy because it is viewed as doing its job well. Unfortunately, this is not enough. Bad luck alone might cause it to lose this source of legitimacy in the future. It is, thus, crucial that the ECB also be viewed as accountable.

Schedler (1999) provides a typical definition of accountability: "A is accountable to B when A is obliged to inform B about A's (past or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct". From this definition, it is seen that accountability has

three components for the ECB: first, the public should be able to observe or be provided with the relevant information about the ECB's actions and decision-making processes; second, the ECB should explain and justify its actions; third, it should be possible to punish ECB policy makers who engage in bad or incompetent behaviour. The first two components are often referred to as *formal accountability*; the third component is often referred to as *substantive accountability*.

The ECB's extraordinary degree of independence precludes the possibility of substantive accountability. Members of the Executive Board serve eight-year, non-renewable terms; NCB governors serve at least 5-year terms. Their compensation is internally decided. Governors of NCBs and members of the Executive Board can be fired only in the event of incapacity or serious misconduct; mere gross incompetency does not count. It is clear that no one, not the European Parliament, nor the Council of Ministers, nor the European Commission can impose sanctions on the ECB. It is telling that while the Federal Reserve Board Chairman *testifies* before the US Congress, the President of the ECB has a quarterly *dialogue* with the European Parliament.

As it does not have substantive accountability, for the ECB to have legitimacy it must be formally accountable. For there to be formal accountability, the ECB must be transparent: that is, it must inform the citizenry of its actions and decisions and justify them. Unfortunately, the ECB – notoriously opaque in its conduct of monetary policy – is demonstrating

perhaps even less transparency in its financial stability role.<sup>3</sup> In the rest of this paper I consider some examples where transparency is or might be lacking.

### *The ECB's procedures for collateralised lending*

The ECB is far from transparent in its procedures for collateralised lending. It is not clear how it values illiquid marketable securities or how it decides upon a haircut.

When the ECB values marketable securities as collateral, it uses market prices, if they are available. If not, it computes *theoretical prices*. Unfortunately, the public is not informed, even with a lag to protect market-sensitive information, what these prices are. Nor will the ECB divulge its methodology or models. Without knowing how it computes these prices, outside observers cannot evaluate whether the ECB is pricing risk correctly, or instead is subsidising or taxing particular counterparties.

Members of the ECON committee in their Quarterly Dialogue with the ECB have attempted to extract information about this from President Trichet. On one occasion a member asked, "To increase its legitimacy, the ECB should publish the minutes of the Governing Council meetings ... And should not this transparency also apply to the internal models used to value [il]liquid collateral?" Trichet ignored the question and said, "We have transformed the way transparency is looked at."<sup>4</sup> When another member asked about how asset-backed securities are valued, Trichet said, "As regards the way we value the ABS, we have our own way of going through a hub in the system. This is done by the system in ways which I considered appropriate but that we

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<sup>3</sup> Post-meeting statements that appear pre-cooked are no substitute for published votes and minutes.

<sup>4</sup> The Committee on Economic and Monetary Affairs of the European Parliament's Quarterly Dialogue with the ECB, December 2009.

can improve at any time if we judge that they should be improved – as we have demonstrated very recently, because the last improvement dates from only a few days ago.”<sup>5</sup> In other words: the ECB is not going to say and only the ECB has the right to judge its own methods.

After deciding the value of a security, the ECB imposes a “haircut”. If a, say, ten percent haircut is imposed on securities valued at 10 million euros, then they can be used as collateral against nine million euros worth of collateralised lending. Unfortunately, the ECB does not tell us how it determines the haircuts that are imposed.

Haircuts are not typically thought of as a penalty for default risk; this is supposed to be reflected in the security’s value. Instead, they might be viewed as a compensation for a loss of liquidity. For marketable securities this could be illiquidity due to asymmetric information problems. They might also be viewed as compensation for taking on correlated default risks of the ECB’s counterparty and of the issuer of the security offered as collateral by the counterparty. If there is a non-trivial risk that a systemically important institution might default and if it is not known which potential borrowers would be in danger of defaulting if that institution defaulted, then it is reasonable to increase the haircut on the debt of the systemically important institution above what it would otherwise be.

The haircut on Greek government debt, despite the Greek sovereign being systemically important and having a non-trivial possibility of default, is the same as the haircut on the debt of the other Euro Area national

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<sup>5</sup> The Committee on Economic and Monetary Affairs of the European Parliament’s Quarterly Dialogue with the ECB, December 2009.

governments or that of the Eurosystem.<sup>6</sup> In addition, the haircuts on all government and Eurosystem debt rise sharply with the maturity of the debt, even when this debt is readily tradable in secondary markets at all maturities. Neither of these rather surprising phenomena have been adequately explained by the ECB. In addition to being non-transparent this could lead to – perhaps unfounded – suspicions that the ECB does not have a coherent view of what should determine a haircut.<sup>7</sup>

#### *The ECB's outright purchases in dysfunctional markets*

On 9 May 2010 the Governing Council decided, “To conduct interventions in the Euro Area public and private debt securities markets (Securities Markets Programme) to ensure depth and liquidity in those market segments which are *dysfunctional*.” (italics mine) As of 28 May, the ECB had bought 26.5 billion euros worth. This is a sizable amount of money. A dysfunctional market is typically characterised by asymmetric information and adverse selection. A counterparty who can sell Greek government debt to the ECB at a price that it could not get in the market may be better off than another entity that is not given that opportunity and it has the possibility of gaining at the expense of the ECB.

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<sup>6</sup>Currently, Greek sovereign debt is rated BBB<sup>-</sup> (minimum investment grade) by Fitch and BB<sup>+</sup> (“junk”) by Standard & Poor’s. Moody’s gives it the highest rating: A3 (upper medium grade). Since it is the highest rating that applies, Greek sovereign debt continues to be subject to the same haircut as any other Euro Area sovereign debt. Should Moody’s downgrade Greek sovereign debt to BBB<sup>-</sup>, then Greek government debt would be subject to an extra five percent haircut. The ECB has not specified what the haircut on Greek debt would be should it sink into the junk category.

<sup>7</sup>At the 23 May 2005 Quarterly Dialogue between the ECB and the European Parliament, a member the Parliament noted that all Euro Area government debt is treated as equivalent and asked if the ECB is willing to differentiate between debt. The representative of the ECB responded that market valuations might change but the ECB would not “introduce[e] a particular judgement”.

Because of its potential to redistribute wealth the ECB must be transparent about how it chooses its counterparties. Once sufficient time has passed to ensure that the information is no longer market sensitive, the details of these outright purchases should be publicly available. The citizenry should know who was able to sell what, how much and at what price. In the absence of this, some might suspect – even if it is not true – that after the supervisory and regulatory failures of certain Euro Area governments allowed some of their banks to become highly exposed to Greece, the ECB helped these governments to bail out their banks by buying back the debt at a rate that was more favourable to them than what was on offer in the market.

#### *Icelandic love letters*

In this section I detail a particularly egregious example of a lack of ECB transparency – and, perhaps, competency.

It was a common practice in Iceland for two banks to swap their debt securities with each other and to use the other's debt as collateral in their borrowing from the central bank of Iceland. This collateral was referred to as *love letters*.<sup>8</sup> Rather surprisingly, the central bank of Iceland was not the only monetary authority to accept love letters as collateral.

Between the start of February and the end of April 2008 subsidiaries of the three large Icelandic banks (which were eligible counterparties of the Eurosystem in Luxembourg) increased their borrowing from the central bank of Luxembourg (CBL) by 2.5 billion euros and a significant fraction of the collateral was in the form of love letters.<sup>9</sup> It is questionable whether the debt of an Icelandic bank should have been acceptable collateral for any borrower,

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<sup>8</sup> Hreinsson et al (2009), p. 44, Flannery (2009), p. 101 and Jännäri (2009), p. 18.

<sup>9</sup> Hreinsson et al (2009), p. 44.

but given the likelihood that if one of the Icelandic banks failed the other two would as well, it should never have been acceptable collateral for another Icelandic bank.

On 25 April 2008 ECB President Jean-Claude Trichet phoned Icelandic central bank governor Davið Oddsson and demanded a meeting with representatives of the Icelandic banks. As a result, an agreement was reached on 28 – 29 April to limit the use of the love letters as collateral. This was not effective and by the end of June, loans to Euro Area subsidiaries of Icelandic banks had risen sharply to 4.5 billion euros.<sup>10</sup>

On 30 June the CBL advised Landsbanki, one of the three large Icelandic banks, that it could no longer use love letters for more than a quarter of its collateral and that it must phase out the use of this type of collateral altogether.<sup>11</sup> At the end of July, the CBL finally prohibited the use of love letters and lending to the Icelandic banks fell back to 3.5 billion euros.<sup>12</sup>

It appears that, apparently frustrated by this turn of events, the badly behaved Landsbanki then took its love letters to the central bank of Iceland. It used its borrowing to purchase Icelandic-krónur denominated Icelandic government or government-guaranteed debt. It then set up a company called Avens B.V. The assets of this company were the Icelandic debt and Icelandic bank accounts; its liabilities were euro-denominated debt. Landsbanki appears to have then successfully presented this euro-denominated debt as collateral in further borrowing from the CBL.<sup>13</sup>

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<sup>10</sup> Hreinsson et al (2009), p. 44.

<sup>11</sup> Flannery (2009), p. 101.

<sup>12</sup> Hreinsson et al (2009), p. 44.

<sup>13</sup> Central Bank of Iceland news report, 15 May 2010. Either the CBL was overly trusting and did not look too closely at what it was being offered or it did not consider the correlated risks. The Icelandic banks had assets that were about 11 times Icelandic GDP. If the banks failed,

In the autumn of 2008, five counterparties defaulted on their Eurosystem loans and three of these were the subsidiaries of the Icelandic banks.<sup>14</sup> At the March 2009 Quarterly Dialogue with the ECB, a member of the ECON committee of the European Parliament asked President Trichet about the CBL's loans of 800 million euros to Kaupthing (another of the Icelandic banks) and 1 billion euros to Landsbanki, saying, "What do you think of this? Is there any dialogue on this subject? It is an enormous risk after all!" President Trichet responded with, "I do not know the details – you are very well informed: you are better informed than I am. I have to say, at the moment – but I have no doubt that the Luxembourg bank is complying precisely with the requirements imposed by its position as a member of the Eurosystem and is applying the Eurosystem rules to the banks that submit eligible collateral to it."

During the crisis, the ECB might have been right to keep certain market-sensitive information from the citizenry. The Icelandic banks, however, had met their demise almost half a year earlier. So, why couldn't the ECB answer the European Parliament's question?

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Icelandic-krónur denominated Icelandic government or government-guaranteed debt was unlikely to retain its value.

<sup>14</sup> European Central Bank, "Eurosystem Monetary Policy Operations in 2009," Press Release, 5 Mar. 2009.

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