From:	Azerad, Robert [RAzerad@lehman.com]
Sent:	Thursday, June 12, 2008 9:22 PM (GMT)
To:	Tonucci, Paolo [paolo.tonucci@lehman.com]; Pellerani, Carlo [carlo.pellerani@lehman.com]; Vecchio, Laura M [LVecchio@lehman.com]; Goldband, Craig [cgoldban@lehman.com]; Domenici, Henry [henry.domenici@lehman.com]; Telmer, Colin [colin.telmer@lehman.com]
Subject:	Economist article on bank liquidity

FYI

Robert
====
Bank liquidity

Litterbin of last resort
Jun 12th 2008 | FRANKFURT
From The Economist print edition

The assets being dumped on the ECB do not look very recyclable
OH DEAR, it was not meant to be like this. The European Central Bank (ECB), widely praised for providing banks with ample liquidity during the credit crunch, now has a problem: how to encourage banks to place freshly created asset-backed securities (ABS) with investors, rather than dumping them, like so much radioactive waste, in its vaults.
The ECB accepts a wide range of assets, including those such as ABS for which there is temporarily very little trading, as collateral in its refinancing operations. Provided the tranche of securities is the most senior, and rated A- or above, the ECB will take it. No surprise then that since August a large number of banks have designed ABS tranches, backed mostly by mortgages, purely for ECB consumption. Of €208 billion ($320 billion) of eligible securities created, only about €5.8 billion have been placed with investors, according to calculations by JPMorgan. In one noteworthy deal in December, Rabobank, a Dutch institution, issued €30 billion of mortgage-backed securities, €27 billion of which were designed exclusively for refinancings with the ECB.
On the face of it there is no immediate problem. Only around 16% of the ECB's collateral so far is ABS. Banks are drinking from the liquidity fountain and keeping the cost of high-street mortgages contained at the same time, which they might not be able to do otherwise.
But it is not helping the revival of a publicly traded ABS market, and may be fostering the creation of even murkier securities. Many of today's ABS are even less transparent than those sold before the crisis—the ECB requires a rating by only one agency, not the usual two, and pre-sale reports are often sloppily prepared. That, at least, is the concern of some rival central bankers, although the ECB itself is not panicking, yet. José Manuel González-Páramo, an ECB director, urged bankers earlier this month to make "serious efforts to revive the interest of third-party investors". Though action is needed, the bank will not do anything in a rush—the markets are still too fragile for that.
All the main central banks have learnt a lot from this crisis. America's Federal Reserve and the Bank of England found that they had too few tools to cope with the liquidity drought. The Fed threw open its emergency lending facilities to investment banks, as well as accepting a much broader range of collateral in its open-market operations. The Bank of England, several months too late, widened the range of collateral it accepts as well. Only the ECB, rather smugly, can say that it has stuck to its pre-crisis rules. But there are still gaping differences that can be "gamed", or arbitraged, between the three systems.
The Fed accepts complex credit derivatives in its liquidity operations, which the others do not; the Bank of England, with its Special Liquidity Scheme dating from April, accepts AAA securities of all types, but only those held on a bank's balance sheet before the end of last year. The British bank also applies more stringent "haircuts"—ie, it is tougher on valuations—than the ECB, according to market participants. The result, unless the ECB changes its tune, is that it could well end up as the repository of last resort. If banks start to default, the ECB—and ultimately the euro-zone taxpayer—could be left holding a lot of toxic assets. Almost as bad—for those with a mind for justice—is the thought that the same supposed rocket scientists, using the same benighted techniques that caused the mess, may be taking everyone for a ride again.
Central bank liquidity policy needs refining and harmonising, as the Financial Stability Forum, a group of banking-industry regulators, made clear in a report in April. This week Mervyn King, the Bank of England's governor, hinted at plans for an integrated framework "making clear the terms on which liquidity will be provided in times of stress".
Market participants say the trouble is that spelling out those terms beforehand can create moral hazard and encourage recklessness. One argument doing the rounds is that the ECB's broad acceptance of collateral before the crisis may actually have added fuel to the fire.

