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ECB suspends use of Greek bonds as collateral

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The headquarters of the European Central Bank

The European Central Bank on Tuesday reacted to Standard & Poor's decision to downgrade Greece to "selective default" by temporarily suspending authorisation for Greek bonds to be used as collateral by banks seeking funds from the central bank.

Any ensuing liquidity needs would have to be met instead through so-called "emergency liquidity assistance" to banks from national central banks, the ECB said.

The fact that Greek bonds would not be eligible as collateral at the ECB once deemed in selective default had already been anticipated, but the move highlights eurozone authorities' slowness to put in place measures agreed to support the Greek debt exchange.

Eurozone heads of state had agreed in effect to offer alternative collateral via the eurozone bail-out fund, the European Financial Stability Facility. However, this support is not yet in place and the ECB said it was expected by mid-March, prompting the call for national central banks to offer emergency assistance as a stopgap.

S&P downgraded Greece to "selective default" grade on Monday in response to the launch of the private sector involvement in a €206bn debt restructuring.

S&P said the downgrade followed the retroactive insertion by Athens of a "collective action clause" forcing all bondholders to accept the terms of the deal put forward by the government for bonds issued under Greek law.

The agency added that the move "constitutes the launch of what we consider to be a distressed debt restructuring... we believe the retroactive insertion of CACs will diminish bondholders' bargaining power in an upcoming debt exchange".

The Greek finance ministry brushed off the move, which marks the first time an advanced economy has been in default since Germany in 1948, and said the downgrade was "pre-announced and all its consequences have been anticipated, planned for and addressed" by eurozone partners who are backing efforts by Greece to avoid a disorderly default.

A successful completion of the debt restructuring would clear the way for Athens to receive a second €130bn bail-out from international lenders, in return for implementing a fresh round of fiscal and structural reforms. Greece is expected to remain in selective default until its debt swap offer closes on March 12.

The ministry said that on completion of the PSI Greece's sovereign rating is expected to be revised upwards to triple C.

Separately, the International Swaps and Derivatives Association said it would decide whether to investigate if the restructuring of Greek debt constituted a default. ISDA said it had received a request from an unidentified party to rule on whether the debt restructuring constituted a "credit event" and would therefore trigger CDS pay-outs. The decision would be announced after markets close on Wednesday, ISDA said.

Greek bonds are being used by mainly Greek banks as collateral at the ECB, which protects its position by accepting the bonds at market value with an additional "haircut" depending on the maturity of the bond offered.

Greece's banks are already highly dependent on emergency liquidity assistance from their own central bank, partly because they have limited amounts of collateral that is eligible for ECB operations. Greece's finance ministry said the downgrade would have no effect on the country's banking sector.

Bondholders face a possible 75 per cent cut in the value of their holdings as a result of the debt swap. They would receive a package of new instruments with a nominal value of just 46.5 per cent of the par value of their current Greek bonds.

S&P's downgrade follows a similar move by Fitch, which last week cut Greece's long-term rating to one notch above default, citing the bond swap arrangement.