Daily Note

8 REASONS WHY TLTRO-III COULD DISAPPOINT

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- **ECB's policy announcements came ahead of expectations**
- **But markets may still be disappointed**

In the latest monetary policy meeting on March 7, the European Central Bank (ECB) announced a set of three measures, the timing of which was ahead of consensus expectations. While the timing of the ECB policy changes was broadly in line with our expectations, the details available so far could leave room for disappointment.

By way of a quick recap, the central bank announced a third round of targeted long-term refinancing operations – TLTRO-III and pushed back its forward guidance on interest rates. The ECB also extended its fixed-rate tender procedures with full allotment to March 2021 (from December 2019). Meanwhile, it sharply lowered its growth and inflation forecasts for this year.

Specifically on TLTRO-III, the ECB will provide cheap funding to banks between September 2019 and March 2021. Each loan will have a maturity of two years. Banks will be entitled to borrow up to 30% of their stock of eligible loans as at 28 February 2019 at a rate indexed to the marginal refinancing operations (MRO) rate. Loans provided under TLTRO-III will have a built-in incentive structure such that it encourages lending to the private sector: in other words, the more the banks lend, the more subsidies they get from the ECB.

The important details on TLTRO-III which could be crucial in determining its impact are not available yet. These include the composition of eligible loans, the floor on the funding rate, the relevant benchmarks banks must meet to qualify for interest-rate subsidies, and whether the 30% cap on TLTRO-III borrowings includes the funds that banks have borrowed under TLTRO-II. While these details will be announced in 'due course', we list 8 reasons why markets may be disappointed by the latest ECB package.

1 Loans of shorter maturity: Under TLTRO-III, seven rounds of auctions will be conducted between September 2019 and March 2021. Each loan will have a maturity of two years. By comparison, TLTRO-II borrowings had a maturity of four years.

2 Floating interest rate: The interest rate of TLTRO-III borrowings are indexed to the MRO rate over the life of each operation. By contrast, the interest rate on TLTRO-II borrowings was fixed at the MRO rate prevailing at the time each TLTRO was conducted. Accordingly, under TLTRO-III, there is a greater built-in risk from the ECB raising interest rates.

Points 3 and 4 are conjectures as these details are not yet published.

3 Limited capacity for Italian and Spanish lenders to borrow under the new TLTRO scheme: Under TLTRO-III, banks are entitled to borrow up to 30% of their stock of eligible loans as at 28 February 2019. It seems more likely than not that the 30% cap on TLTRO-III borrowings includes the funds that the lenders have already borrowed under TLTRO-II. This would mean that the benefit from the new scheme to Italian and Spanish banks could be very limited.

Specifically, under TLTRO-II, banks were able to borrow up to 30% of eligible loans (loans to non-financial corporations and households excluding mortgages) that they were holding on their balance sheet at end-January 2016. Italian banks alone borrowed 33% of funds extended through TLTRO-II, followed by Spanish lenders who took up 23%. These banks have just exceeded 80% of their TLTRO–II borrowing limit. So their capacity to take on new borrowings under TLTROs-III could be modest.

Additionally, ECB Governing Council member Vitas Vasiliauskas dismissed the idea that the stock of eligible loans could be increased by including mortgages.

4 There is uncertainty about what the floor rate on TLTRO-III borrowings will be and what benchmarks the ECB will apply for banks to benefit from TLTRO-III subsidies. The shorter maturity of TLTRO-III loans and flexible interest rates could suggest that the modalities for TLTRO-III borrowings could be less generous in comparison to those for TLTRO-II loans.

5 Bridging the funding gap between June and September: Markets may be anxious about rolling over their TLTRO-II borrowings between June-2019 (when the funding 'cliff edge' starts to bite) and the September -2019 starting date for the first series of TLTRO-III borrowings. We think banks can rollover their maturing debt using the ECB's fixed-rate full allotment (FRFA) refinancing operations under which lenders can borrow an unlimited amount of funds from the Eurosystem at the existing MRO rate of 0% for up to three months. Admittedly, the effective cost of borrowing using the 3-month FRFA procedure could be more than that under TLTRO-II where banks could get a subsidy of up to 40bps from the ECB.

6 The ECB sharply revised down its growth forecast to below consensus expectations: The ECB downgraded its growth forecast for this year to 1.1% from the earlier projection of 1.7%. Yet, it sees risks titled to the downside. The downward revision was in line with our expectations, but it has disappointed the consensus. For instance, according to a Bloomberg survey, analysts were expecting real GDP to expand by just below 1.5% before the ECB meeting.

7 The most important point is that TLTROs do not address the problem of weakening eurozone growth and loan demand. Credit-easing measures such as TLTROs are helpful when banks are constrained in their ability to meet the demand for credit. But it is mainly weak demand (especially in Italy) that has held back bank lending in the EA in this cycle. In spite of the ECB providing a subsidy of up to 20% through the TLTRO-II facility, the impact on credit growth and economic expansion has been muted so far. For instance, loans to the private sector excluding mortgages have continued to contract in Italy and Spain – the largest borrowers of TLTRO funds. TLTRO-III is unlikely to change this.

8 TLTRO-III merely postpones the funding risks for Italian and Spanish banks to sometime between September 2020 (when new TLTRO-III loans become sub-1-year) and March 2022, depending on how and when the banks roll over their TLTRO-II borrowing. We discuss these themes in our latest Global Financial Trends publication, the TLTRO Bazooka.