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Flash Note

Euro area: ECB monetary policy

Large take-up for ECB's final TLTRO is good news for bank credit

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The fourth and final ECB's Targeted Long-Term Refinancing Operations (TLTRO) attracted EUR233bn in demand from 474 euro area banks, well above consensus (EUR110bn). Expectations of an ECB deposit rate hike may have boosted demand for this operation, as it provided a last opportunity for banks to secure four-year funding at a rate that can go as low as -0.40%.

There is no breakdown for takeup of TLTRO loans available across countries. We estimate that banks in Italy and Spain account for at least 60% of total TLTROs holdings. Peripheral banks are likely to benefit most from negative TLTRO rates, provided that lending improves further in Italy, Spain, Portugal and Greece.

Since TLTROs were introduced, the transmission of monetary policy has improved further, providing a 0.3-0.4% boost to euro area inflation over a two year horizon in our estimates.

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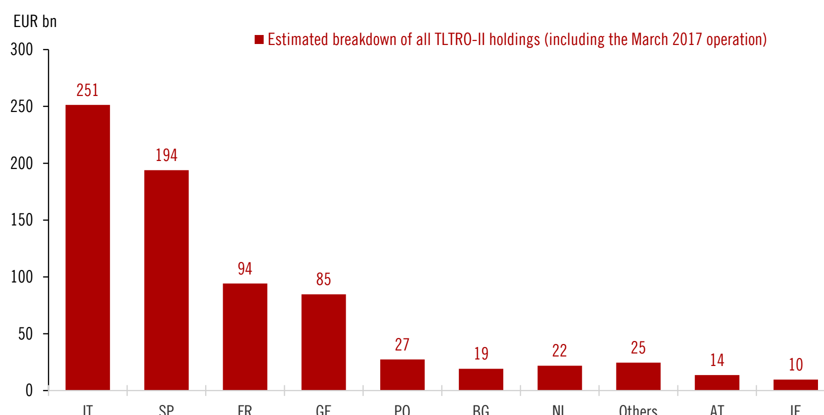
Demand for liquidity at the ECB's fourth and final Targeted Long-Term Refinancing Operation (TLTRO-II.4) was larger than expected, with EUR233.47bn allotted to 474 euro area banks. We have long been of the view that TLTROs have made a significant contribution to the improvement of the macro outlook in the euro area, lowering bank funding costs, mitigating the cost of negative rates, and boosting credit supply (see "Scepticism over ECB's TLTRO II is misplaced"). In short, TLTROs have improved the transmission of monetary policy, boosting inflation by 0.3% over two years according to our initial estimates.

There is no breakdown available across countries but peripheral banks are likely to benefit most from TLTROs, in our view. However, banks in Italy, Spain, Portugal and Greece will have to increase private sector lending in the coming months in order to get the lowest TLTRO rate possible (-0.40%).

Chart 1: estimated breakdown (*) of all TLTRO-II holdings



Source: Pictet WM – AA&MR, ECB, National Central Banks (under the simplistic assumption that the country shares are the same in the March 2017 TLTRO as in the previous three operations)*

Explaining strong TLTRO demand

The EUR233bn allotment at the final operation will push total usage of TLTRO- II to EUR740bn (of which more than EUR400bn have been rolled over from TLTRO-I). The following factors likely boosted demand:

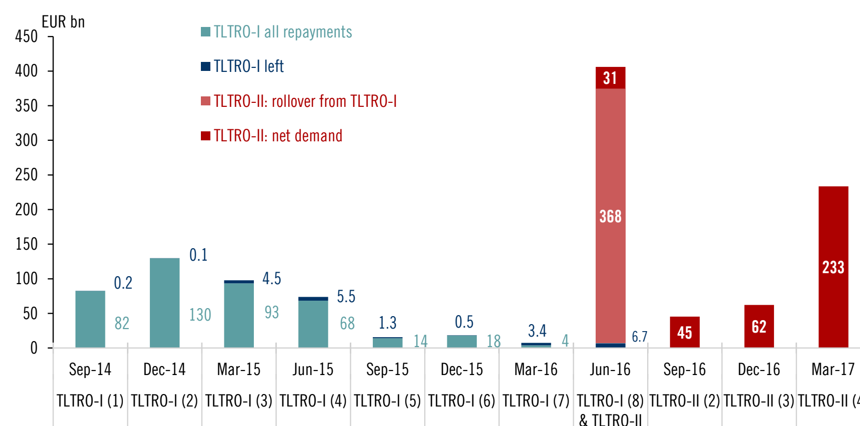
- TLTRO-II.4 was the last opportunity for banks to secure 4-year funding at no *ex ante* cost, and with an *ex post* interest rate that could be as low as the ECB's deposit rate (-0.40%), depending on an

improvement in bank lending. We describe the TLTRO modalities below, including the two main differences with the first series of TLTRO-I: 1) the total amount banks were allowed to borrow were larger, equivalent to 30% of their eligible lending portfolios; 2) the TLTRO-II rate depends on bank net lending behaviour relative to a benchmark, between -0.40% and 0%, but with no penalty in case of a failure to meet the benchmark. In short, **TLTRO-II provided a free liquidity option for banks with a 40bp upside**.

- A subtle hawkish shift in the ECB's stance in March has fuelled market expectations of an early deposit rate hike by Q1 2018. As a result, **fixed-rate TLTROs have become more attractive**.
- Banks have more visibility in terms of their lending capacity over the relevant period for TLTROs (January 2016 – January 2018), and thus can better estimate the likelihood of meeting their benchmarks.

Chart 2 shows the history of all TLTROs since H2 2014, including repayments from previous operations. A total of EUR16.7bn will be repaid from TLTRO-I.1 and TLTRO-I.3 on 29 March 2017, so that **the net injection of liquidity from TLTRO-II.4 will be EUR217bn**.

Chart 2: History of TLTROs



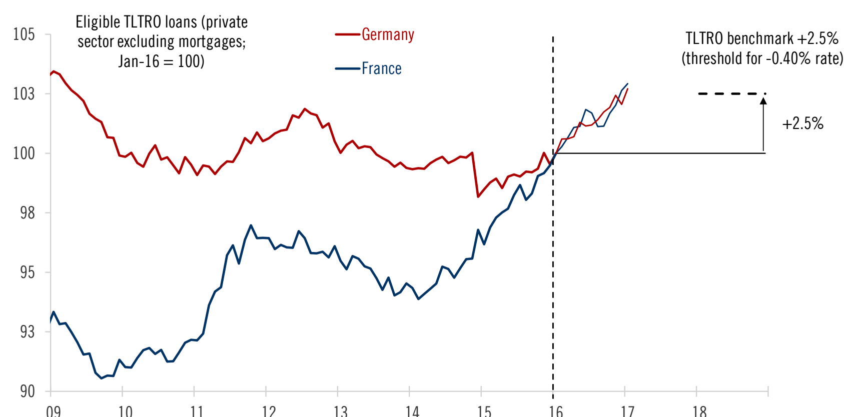
Source: Pictet WM – AA&MR, ECB

Peripheral banks to benefit most, provided credit supply rises

Estimated breakdowns of TLTROs across countries are only available up to February 2017, using national central bank data. Chart 1 shows our estimates including the final TLTRO-II. Extrapolating from the share of each country in previous operations, **Italy and Spain would account for at least 60% of total TLTROs holdings**.

The extent to which banks will benefit from a lower TLTRO-II rate will depend on their net individual lending until January 2018. Based on available lending data up to January 2017, it looks likely that most banks in core countries (except the Netherlands) will benefit from a full discount and a -0.40% interest rate. In Germany and France, banks are already above the maximum benchmark (+2.5%) in terms of their net lending— 0.2% above that threshold in Germany, and 0.4% in France.

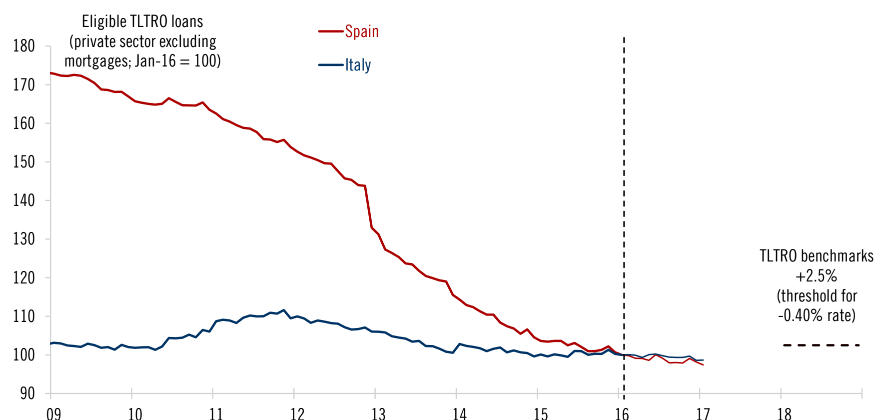
Chart 3: banks in Germany and France should easily qualify for a -0.4% rate



Source: Pictet WM – AA&MR, ECB

In absolute terms, banks in peripheral countries are expected to benefit most, provided their eligible net lending exceeds the ECB's benchmarks. Based on available data, banks in Italy, Spain, and Portugal will have to increase private sector lending in the coming months in order to qualify for the lowest TLTRO rate possible (-0.40%), although they would face no penalty if they didn't.

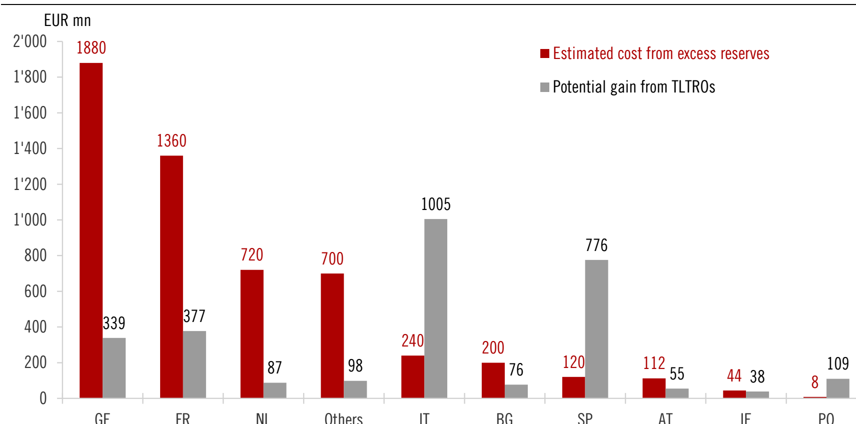
Chart 4: banks in Italy and Spain need to increase lending to qualify for a -0.4% rate



Source: Pictet WM – AA&MR, ECB

In aggregate, the maximum subsidy from those long-term loans at a negative rate is EUR3bn on an annual basis, compared with a total cost of the ECB's negative deposit rate of around EUR5.5bn (a number that will grow to over EUR8bn as QE continues).

Chart 5: Estimated breakdown of excess reserves and potential gains from TLTROs



Source: Pictet WM – AA&MR, ECB, national central banks

No game-changer, but a boost to growth and inflation

We continue to believe that the macroeconomic effects of the ECB's TLTROs have been underestimated. When the second series of TLTRO-II was announced in March 2016, we initially estimated that an improved transmission of monetary policy could contribute to boosting inflation by around 0.3% over two years (see "Euro area: quantifying ECB's stimulus – an extra 0.3% boost to inflation").

Since then, the ECB has extended QE (at a slower pace of EUR60bn per month from April 2017 to December 2017), which would push our rough estimate of 'improved transmission' to above 0.4%. Meanwhile the latest ECB's Bank Lending Survey noted that the "easing impact of TLTROs on credit standards increased". Today's economic bulletin also has a full box on the impact of ECB's non-standard measures on financing conditions, with a very positive assessment of TLTROs in particular (page 49).

Looking ahead, TLTROs could still prove to be a useful tool in the future in the event of downside risks materialising, as Mario Draghi indicated during his last press conference. Even if no new operations are announced, the ECB could always ease the terms of the existing ones, for instance by increasing their maturity as needed.

Appendix: TLTRO-II modalities

The ECB conducted a series of four TLTRO II operations each quarter between June 2016 and March 2017, with a fixed maturity of four years and an interest rate as low as the deposit rate (currently -0.40%). **TLTRO II offered long-term funding to banks with much more favourable terms and conditions than TLTRO I** (see details here):

- **Borrowing amounts**: banks were allowed to borrow up to 30% of the amount of eligible loans (all loans to non-financial corporations and households with the exception of mortgages) that they were holding on their balance sheet at end-January 2016, net of any residual amount borrowed in the first two TLTRO I operations conducted in 2014. At the aggregate euro area level, this resulted in a potential **TLTRO II allowance of around EUR 1,500bn**.
- **Maturity**: TLTRO II operations have a **fixed maturity of four years** (up to March 2021) as opposed to a fixed term (September 2018) for the TLTRO I programme.
- **Interest rate**: the rate applied to TLTRO II will initially be fixed at the refi rate (0% currently), similar to TLTRO I, but banks will be granted a reduction by 2018 (with retroactive effects), depending on them meeting specific conditions linked to lending benchmarks. At best, banks will end up 'paying' the ECB's deposit rate, ie *receiving* 0.40% annually on the amounts borrowed from all TLTRO II, if they exceed their benchmark by 2.5% over two years. The exact formulae is complicated, with a distinction made between banks whose eligible loans expanded over the 12 months to January 2016 ('lending banks') and banks whose eligible loan portfolios shrunk over the same period ('deleveraging banks').
- **Repayments**: banks will have the option to repay TLTRO II each quarter starting in 2018, but contrary to TLTRO I there will be no mandatory early repayments in cases where the lending benchmarks are not met. The only 'risk' that banks face, should they fail to meet the ECB's (arguably loose) target between February 2016 and January 2018, is that rather than receiving a 0.40% subsidy, TLTRO II loans are priced at 0% for four years.

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