ECB delivers but is running out of options

Stimulus is positive for banks, but not enough to prevent recession

The ECB announced a range of easing measures recently including cutting interest rates, restarting QE and improved lending terms to banks. While these are encouraging for banks and monetary policy transmission, distortions and imbalances are likely to rise in credit markets. Most importantly, the ECB has admitted that its policy is losing its effectiveness, putting pressure on fiscal policy to do more to prevent recession.

Source: iStock

The ECB announces more stimulus

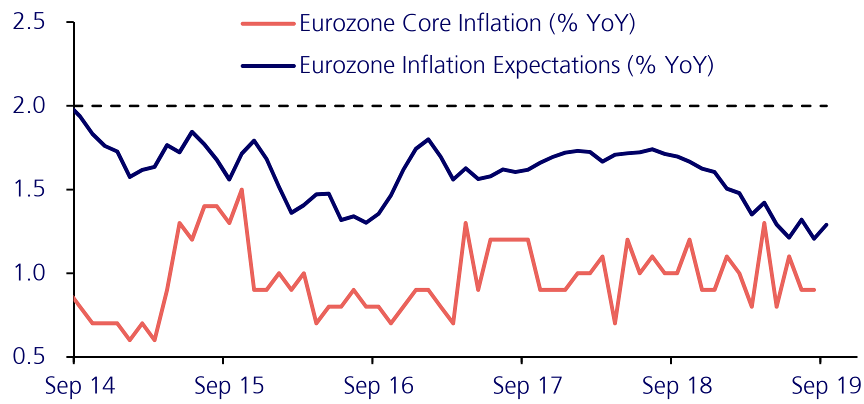
Despite the voicing of serious concerns from various ECB governing council members, Mario Draghi, in his penultimate monetary policy decision before retiring as President of the ECB, was given the benefit of the doubt on September 12 to ease policy through a broad range of measures.

The deposit rate was cut further into negative territory, by 10bps, to -50bps and the ECB said it would re-start Quantitative Easing (QE), albeit at a relatively low amount of 20 billion euros a month from November. Significantly, QE will be open-ended, with no specific end date other than 'to end shortly before' the first interest rate increase.

In addition, forward guidance on interest rates was changed from being date contingent to being contingent on the state of the economy. The ECB said that it would now keep interest rates at present or lower levels 'until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.'

Finally, for the banking sector, the ECB also announced more support, including tiering of interest rates on excess reserves held with the ECB and more favourable TLTRO 3 terms (see later for more on this).

Inflation expectations stabilise, but well below the ECB's target



Source: Bloomberg, Note: The ECB's inflation objective is a rate 'below, but close to, 2% over the medium-term'

Diminishing effectiveness

Despite the broad array of easing policies adopted, the overall impression left by the ECB's decisions is that it is running out of straight forward policy options and its credibility with respect to its inflation target has diminished. The language used to describe the bar for when interest rates will be raised suggests it is trying to sound convincing on its inflation target but is not certain it will get there.

Indeed, Draghi implicitly admitted that ECB easing is losing its effectiveness when he said that fiscal policy is now the 'main instrument' to stimulate demand. We would agree that fiscal policy now needs to do much more if the Eurozone is to avoid recession. (See for example our recent paper: "The Eurozone heads towards recession: Governments need to act decisively to alter the economy's course", Sept 19.

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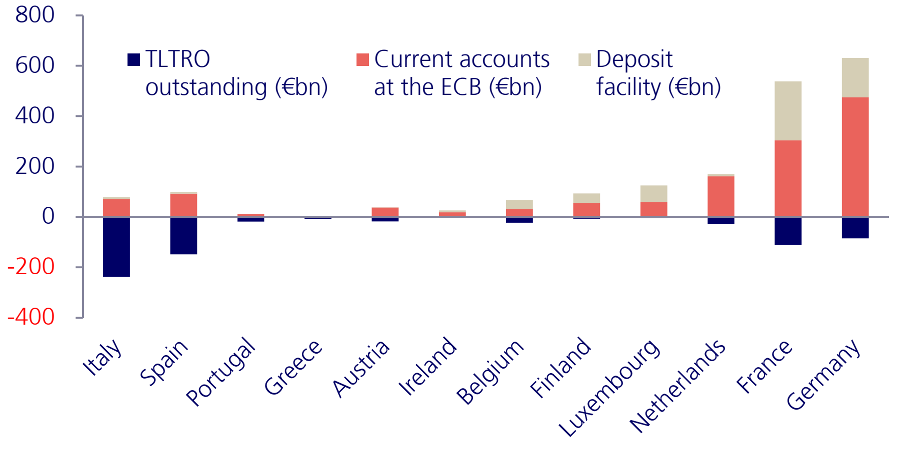
European banks have excess liquidity, although divergences remain



Source: Bloomberg

However, so far the appetite for more fiscal spending from countries in the Eurozone which have the capacity to spend more, especially Germany, is relatively limited, suggesting that things will have to get worst first before they are prepared to act more forcefully.

No change in issuer limits for now

Draghi said there was no discussion of raising the ECB's self-imposed issuer limit of 33% on the amount of any particular government bond issuance that it will allow itself to buy. Rather, he said that the 20 billion euros a month asset purchase programme could continue for 'quite a long time' before hitting those limits. He also confirmed that purchases would be similar to the previous programme, i.e. consisting mainly of government, corporate and covered bonds, and asset-backed securities (ABS).

Downside risks

Concerning the reasons for the decision, the ECB explained, correctly in our view, that it saw risks to the downside for the economic outlook, and that the persistence of these downside risks, specifically those related to trade and other geo-political issues, was a concern. Indeed, as a result, it has revised down its growth and inflation forecasts.

However, Draghi still dismissed the risk of recession in the Eurozone, saying that although the risk had increased it was still a 'small probability'. We would disagree and say that the Eurozone falling into recession sometime in the next few quarters is actually our base case.

Market impact: Equities and bonds

The package of measures should still help keep Eurozone equity markets supported in the near term and periphery spreads in government bond markets tight. The ECB also appears to have been successful in stabilising inflation expectations for now, albeit at a low level.

However, without an aggressive fiscal policy boost as well, it does not change our base case that the Eurozone will slow further over the coming quarters, with a high chance of recession. Hence, the boost to risk assets from the ECB action may ultimately prove to be relatively short-lived.

The ECB's QE is positive for credit short term, but increases risks longer term

We think that the boost to credit markets from the ECB's QE will likely cause spreads to tighten in the short term, although distortions and imbalances will increase fundamental risks in the long term.

The ECB is likely to buy credit in its QE program, with the asset mix to remain largely unchanged from last time. This implies that around €2.5bn corporate bonds could be purchased every month in addition to around €1.2bn covered bonds and some ABS. This should boost the demand for credit in a relatively price insensitive fashion, supporting some further spread compression in the short term.

Moreover, the ECB has now announced that it can buy credit yielding less than its deposit rate of -0.5%. This may become important for the covered bond purchases, as around 90% of European covered bonds trade at negative yields.

While both of these are likely to be positive for credit spread momentum in the short term, they can increase fundamental risks for credit investors in the medium to long term. Spread levels are already low and corporate leverage is high. ECB actions will further incentivise an already leveraged corporate universe to return cash to shareholders at the current differential of cost of equity and corporate debt yield. For example, the dividend yield of the Stoxx 600 index of European companies is around 3.7% while the yield on the Barclays European corporate bond index is around 0.4%.

At the same time, distortions are also likely to increase in an environment of significantly negative yielding fixed income. Corporates carry default risk, even though historically these have been low in investment grade credit. However, with a 0.4% yield on typical European corporate indices, investors are not getting paid much more than compensation for default risk. At the same time, some bonds in the high yield market, where historical default rates are around 4%, are trading near zero or negative yields. Default prone bonds are not a good duration hedge in our view but the search for yield, along with the deeply negative front end of the government bond yield curves, pose higher risk of losses for investors when default rates pick up.

In conclusion, while the ECB's QE announcement is likely to be positive for short term momentum in credit, it could cause a rise in long-term risks by creating distortions and potentially increasing corporate leverage, while doing little for the real economy.

The ECB's impact on banks

Nevertheless, the ECB's new policy announcements are positive for banks and for short-term momentum in credit markets. The ECB is taking steps in the right direction for the banking sector, pretty much in line with what we highlighted as actions that need to be taken in our previous publication: "ECB Stimulus misses the mark due to banks", July 19.

ECB actions are supportive for banks and monetary policy transmission…

In a world of negative rates, savers tend to be penalised by paying interest on their cash and borrowers who can borrow at negative rates tend to get paid for borrowing. The ECB's announcement is positive for banks, as banks' net interest margins are likely to be boosted by paying less to the ECB for their cash while getting paid more for their borrowing from the ECB.

In our previous publication, we argued that further rate cuts by the ECB could prove counterproductive. This would especially be the case were the rate cuts to occur without meaningful mitigating measures for the banking system. At the same time, the design of long-term cheap loans for banks was deficient in several respects. Both of these would be impediments to monetary policy transmission.

Our reasoning was based on the argument that negative rates act as a tax on banks with excess cash. Currently, the European banking sector is sloshing with excess liquidity of around €1.9 trillion in the form of excess reserves (see figure), which is much more than the €0.7 trillion in loans that banks are borrowing from the ECB under its cheap loan program, technically called targeted long term refinancing operations (TLTROs). These excess reserves are not evenly split within the region. Core country banks have more excess liquidity at the ECB relative to loans from the ECB, while some peripheral country banks are in the opposite position, as shown in the figure above.

Negative interest rates were penalising core country banks, which were paying money to the ECB to maintain reserves, while peripheral banks, which were getting paid to borrow could have theoretically benefited. However, the deficient design of the TLTROs was unlikely to benefit peripheral banks either. This meant that neither core banks nor peripheral banks would benefit from rate cuts, which would hamper the transmission of low rates to the real economy.

Encouragingly, the ECB seems to have acknowledged both these issues for core and peripheral banks and has acted to address them.

..as tiering should boost margins …

So what exactly is the interest rate tiering that the ECB announced and how will it help banks, especially those in core countries?

The interest rate tiering implies that banks will only pay for part of their deposits at the ECB. Without the interest rate tiering, banks would have to pay 0.5% to the ECB on the entire amount of excess reserves. Hence banks in core countries which have so far been paying negative rates on their entire excess reserves will get some relief.

So how much relief will be provided by the interest rate tiering? According to our estimation, for the banking sector in aggregate, the maximum exemption can be a bit more than 40%. This represents a sizeable amount of around €800bn out of the €1.9 trillion excess reserves that banks hold at the ECB. However, in reality, this €800 bn is an upper limit. This is because the ECB has exempted excess reserves up to a limit of six times the minimum required reserves for banks. Hence banks with very large excess reserves will only get exemption on a small part of these reserves. Therefore, in aggregate, the entire €800bn exemption is unlikely to be achieved.

What does this mean for net interest rates charged to the banks? With a simple calculation of maximum exempt reserves charged at 0%, and the rest charged at 0.5%, the blended rate charged to banks is at best 0.27%, not 0.5%, which is a significant relief in our view. That said, the ECB may cut interest rates further, but it can also increase the exemption limit of excess reserves. In fact we expect the exemption limit to be used as a policy tool and be used to fine tune the transmission of monetary policy by the ECB.

…while the new TLTRO design addresses some of the deficiencies

The ECB has also announced some structural changes to the cheap loans given to banks, TLTROs. In our view the TLTROs are quite a powerful tool if banks are able to borrow at negative rates, that is, be paid to borrow money from the ECB which they can then lend out to customers at a healthy spread. While the earlier design of TLTROs was deficient in several respects, the changes introduced by the ECB alleviate some of these deficiencies. There are three main improvements to the structural features that the ECB has announced.

Firstly, funding cost to banks is now 0.2% lower, even more than the 0.1% rate cut. This is because earlier the ECB was charging banks a spread of 0.1% above the underlying rates, which will not be the case now. To illustrate this, the lowest rate at which banks could borrow from the ECB, if they were to meet prescribed lending targets, is now -0.5% versus -0.3% before. So banks can be paid even more now to borrow from the ECB to expand loans.

Secondly, the maturity of the loans has been extended from two years to three years. A two year maturity was too short, as banks tend to lend to customers for longer than two years.

Thirdly, banks will now be allowed to pre-pay loans starting from when they only have one year to maturity. Previously, the ECB had disallowed prepayments which was negative for banks in meeting some regulatory requirements.

In particular, banks need to maintain a Net Stable Funding Ratio (NSFR)—the ratio of stable available funding to stable required funding—above 100%. As soon as a loan to a bank becomes due within a year, it is no longer considered stable funding and for the NSFR it is only counted with a 50% weight, which drops to 0% once it becomes shorter than six months. Hence, the ability to prepay a loan when only one year maturity is left is quite positive and should encourage the take up of the TLTROs.

So overall both the interest rate tiering as well as changes to the TLTROs are beneficial for banks. Theoretically, banks could get paid 0.5% to borrow, while expanding the lending to earn healthy net interest margins. At the same time, depositing money at the ECB would cost banks an estimated best case average of only 0.27%, compared to 0.4% before the rate cut and 0.5% after the rate cut. Under the previous design, banks could get paid at most 0.3% to borrow and pay 0.4% to deposit money at the ECB.

These changes hence could represent a significant improvement for margins, and could encourage lending. While the ECB's new design doesn't solve all the issues facing the European banking sector, which still remains fragile in our view, it provides some relief for banks' profitability, which has been under pressure.

Conclusions

From a macro-economic perspective, the various stimulus measures announced by the ECB are unlikely to alter the outlook significantly. They may help boost investor confidence in the short term, but unless combined with a substantial fiscal policy boost, they are unlikely to do much to boost growth and inflation in the Eurozone.

The ECB's QE is positive for credit markets in the short term, as it adds some price insensitive demand, which acts as a tailwind, but given tight spread levels, which limit further upside, we don't see this being a game changer. That said, we think the low funding costs can encourage further corporate leverage, which would be a long term negative for credit investors.

However, the ECB announcement of interest rate tiering and TLTRO design enhancements are quite positive for the banking sector in Europe, which has been reeling under profitability pressures.

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