ECB stimulus misses the mark due to banks

Despite 'cheap loans', more pain lies ahead for the sector

The ECB is about to fire further monetary stimulus at the Eurozone economy, but we question the impact this will have. With yields on European credit at 0.51% and on 10yr Bunds at -0.36%, the ECB may unintentionally inflict further pain on banks. The risk of missing the target due to impeded monetary policy transmission through weak banks, seems to be underappreciated by both the ECB and financial markets.

Source: Istock

The ECB is about to fire off more stimulus, but will it hit the target?

The ECB has announced new cheap loans to banks (called TLTROs) and hinted at further monetary policy easing. The monetary stimulus, especially rate cuts, may be the last thing which banks need, as they are already reeling from profitability issues amid low yields and a flat curve. With European credit yield at 0.51% and 10yr Bund yield at -0.36%, further easing needs to be targeted in order to be effective, as market pricing is not distressed as it was in 2016 or during the Eurozone crisis. Unless the stimulus is carefully designed, we question whether it will have the desired effect on improving Eurozone growth and inflation.

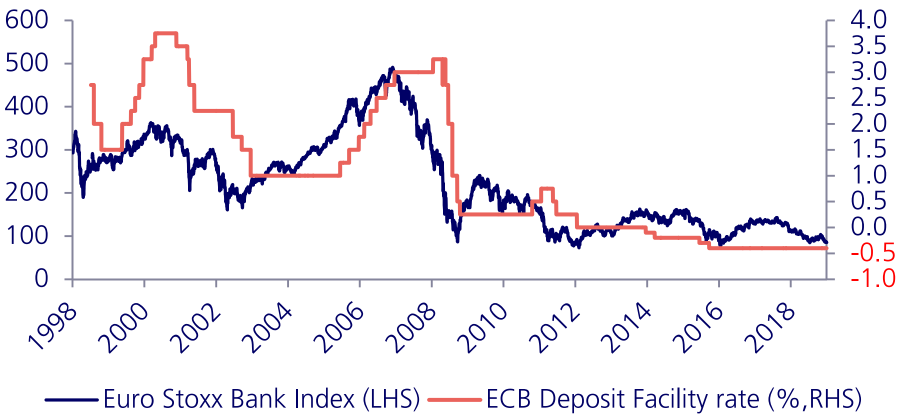
Getting paid to borrow may not be enough for banks

Despite the potential for banks to get paid for borrowing money in the ECB's new cheap loan programs, banks are unlikely to be in a rush to take them up, due to some structural features of the loans. We disagree with those market participants who think the loans are generous. We believe their arguments are overly focussed on the interest rates on offer rather than the structural features of the loans, which are deficient.

The cheap loans, technically called Targeted Longer Term Refinancing Operations (TLTROs), will be offered in seven quarterly auctions from September 2019 until March 2021. They will be the third series of such loans and hence often called TLTRO III. These loans will allow banks to borrow as much as they want, as long as they borrow within prescribed limits, and post eligible collateral. The interest rate will vary between 0.1% and -0.3%, with the lower rate only available if banks lend more than a predefined target to companies and consumers (excluding mortgages). These rates are 0.1% higher than those offered under the previous program, TLTRO II. Notably, the interest rate paid by banks will always be higher than the interest rate that banks earn on their cash at the ECB, which is currently -0.4%. However, unlike TLTRO II, the interest rates in TLTRO III are variable, which means interest rates will be lower if the ECB cuts deposit rates further.

So if the new cheap loans appear attractive on the surface, why do we think banks would not take them up in size? There are three core reasons behind our view:

Rates do matter for banks, along with other factors



Source: Bloomberg

Firstly, the short maturity of these new loans and inability to prepay them is discouraging. The new loans have only a two year maturity, compared to four years in the previous program. This is discouraging for banks as they need to maintain a regulatory liquidity ratio, called Net Stable Funding Ratio (NSFR) above 100%. NSFR is the ratio of stable available funding to stable required funding. When the maturity on a loan falls below one year, it only counts towards the numerator of NSFR with a 50% weight – which will make the NSFR drop. Furthermore, once the loan has reached less than six months to its maturity, it cannot be considered stable funding at all, giving it a 0% weight in the calculation of NSFR. This is made worse by no prepayment being allowed in these loans. Once the NSFR starts dropping and there is only one year to maturity left, banks cannot roll-over loans into a new tranche of the TLTRO III, and will have to suffer the full drop in NSFR. This may become a problem for banks close to a 100% NSFR and also for others who want to target a particular NSFR ratio, even if above 100%. Furthermore, bank loans to customers tend to be of longer maturity and hence, banks would need to assess their ability to roll over funding from TLTRO III after two years.

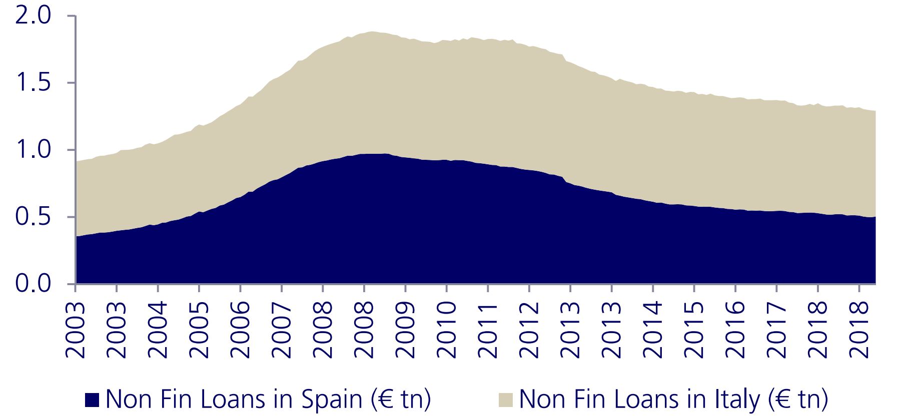
Secondly, borrowing limits would constrain banks that need the cheap loans the most. The limit for overall borrowing is set at 30% of the stock of eligible loans made by a bank (called eligible collateral), but borrowing under both TLTRO II and TLTRO III will count towards the limit. Banks in Italy and Spain are already close to this limit in TLTRO II and hence can at best only roll over loans, rather than expand their borrowing. Furthermore, borrowing at each auction is limited to 10% of eligible collateral, implying banks with large borrowing needs will need to stagger their borrowing and potentially take further hits to NSFR, if old loans under TLTRO II fall due within a year.

Thirdly, the start of new loans in September 2019, rather than June 2019, is a mistake. This is because around € 380bn of existing borrowings under the TLTRO II program (mostly from peripheral banks) fall due by June 2020. This means that the regulatory treatment under NSFR will already become unfavourable by the time TLTRO III loans are made and some banks may already be replacing the funding from TLTRO II by then.

Investors are unimpressed

On the day the ECB announced the full details of the TLTRO III at its meeting of June 6, 2019, the Eurostoxx Bank Index fell. This index has underperformed the broader Stoxx Europe 600 index by around 12% since the beginning of 2019, after underperforming by around 20% in 2018. Disappointment about the new TLTROs is not the only cause of this underperformance as low yields and flatter curves are also drags on the sector among other factors, but a more generous TLTRO could have helped sentiment in our view. A number of banks have already indicated that their take up of TLTRO III is likely to be lower than that of TLTRO II.

Non-financial corporates loan growth is contracting in the periphery



Source: ECB

So why did the ECB underwhelm?

The ECB indicated that the new TLTROs are meant to be a liquidity backstop as opposed to a full-fledged stimulation. The ECB also wants to discourage so called 'carry trades'. Indeed, carry trades, where banks use cheap funding to buy higher yielding government bonds, have increased bank-sovereign linkages, especially in the periphery. That said, the ECB seems to have prioritised the discouragement of carry trades over promoting lending through cheap funding, in our view.

We think more generous TLTROs are a missed opportunity…

We think TLTROs could be an effective offset against negative rates that banks have to pay on deposits and excess reserves at the ECB. Hence, we are not convinced that borrowing under TLTRO programs should be curtailed, especially given the weak inflation dynamics in Europe and poor loan growth to the non-financial corporates sector in some peripheral countries (please see chart). **In fact, in 2018 we were hoping that the ECB would announce a more generous TLTRO III program than TLTRO II, not less.**

…as a shift to alternative funding is easier said than done

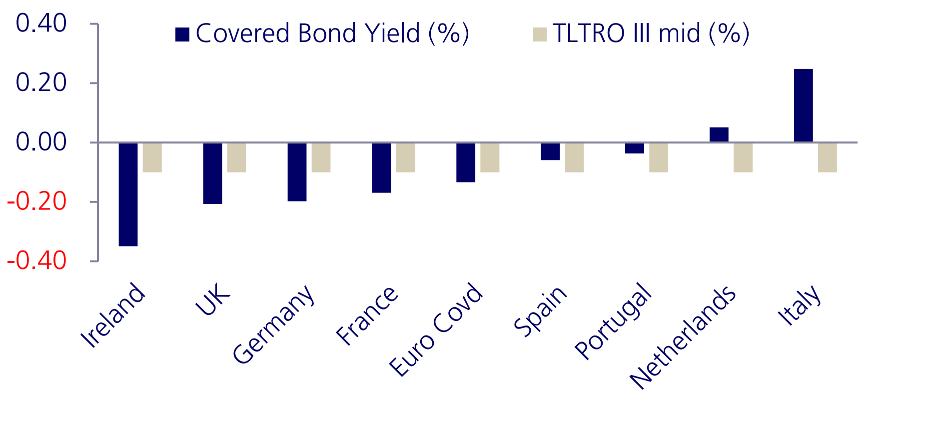
While the ECB wants to wean banks off the TLTROs and use market based funding instruments, this may be onerous for some banking systems in particular.

A somewhat comparable alternative to TLTROs are covered bonds. Covered bonds are issued by banks with a ring-fenced collateral pool, to pay bond investors in case the bank is unable to pay. Hence, they carry a dual recourse: one from the issuing bank and one from the underlying collateral.

However, it is not that easy for covered bonds to replace TLTRO funding for three reasons. Firstly, the rates of borrowing are only cheap and comparable to TLTRO rates for large core country banks, which have hardly drawn on TLTRO funding. For smaller banks from Italy, that are big takers of TLTRO II, covered bond funding is more expensive than TLTRO funding (please see chart).

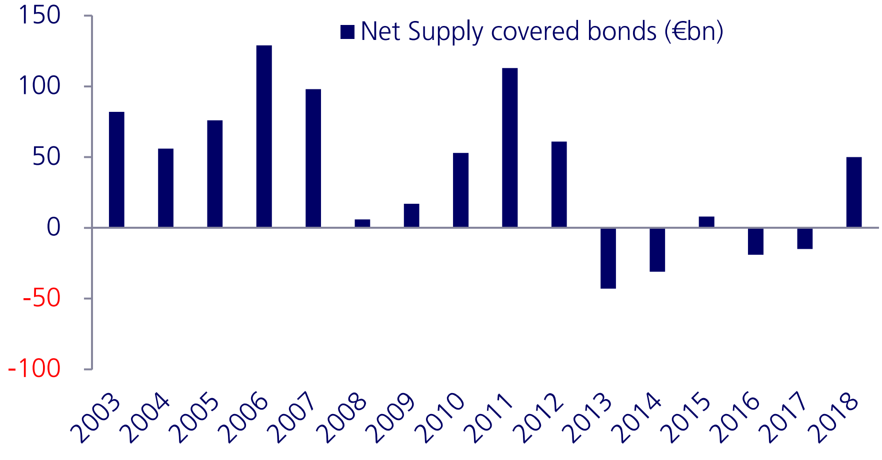
Secondly, the collateral pools required for issuing covered bonds are potentially higher quality and different than those that can be used for TLTROs, which would limit the borrowing possible using covered bonds. Thirdly, in aggregate, the covered bond net supply seems small, as shown in the chart. Hence, it will be a challenge for banks to use

Covered bonds are likely to be more expensive



Source: Bloomberg Notes: Covered Bond yields from Barclays indices as of June 27 2019; TLTRO interest rate range: +0.1% to -0.3%

The covered bond market seems too small to absorb € 700bn



Source: Barclays

covered bonds for anywhere close to a € 700bn volume borrowed under TLTRO II.

These factors will likely force banks to seek other alternatives to TLTROs, such as senior bonds or deposits, which are more expensive.

Worryingly, there doesn't seem to be a clear consensus within the ECB …

The divergence of views within the ECB is concerning. There have been several times when various Governing Council members have expressed different views on the value of TLTROs and impact of negative rates on the banking sector. To us, achieving unanimity for supportive action for banks will be a difficult task. Further complications may arise for the next ECB president, as Mario Draghi is due to step down later this year.

… possibly due to two constraints facing the ECB from the fragmented bank sector

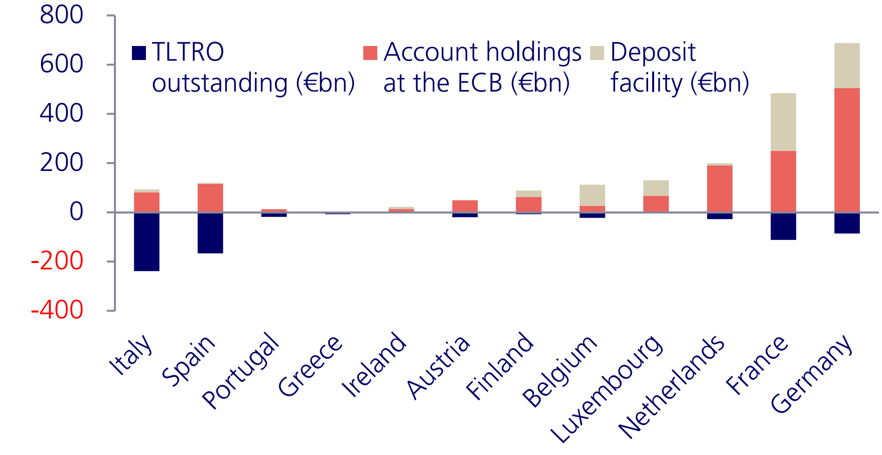
We think the ECB faces two significant constraints in designing monetary policy – firstly the excess liquidity sloshing around in the system and secondly, the fragmented nature of the banking sector.

Given excess liquidity in aggregate in the banking system, along with a negative deposit rate, banks pay the ECB to deposit this liquidity. Cutting rates further may simply act as a tax on banks that are already facing profitability pressures. This is likely to be the case unless banks replace expensive funding by TLTROs funded at negative rates to provide an offset. Alternatively, mitigating measures such as tiered interest rates, where banks pay on only parts of their money with the ECB, would also help.

The other significant constraint facing the ECB is the fragmented European banking sector. This is highlighted clearly in the chart that shows that while banks in the periphery have taken up more funding under TLTRO II from the ECB versus their use of the deposit facility, the situation is the reverse for the core country banks. As a result, while negative rates are hurting core country banks on the whole, they may be somewhat beneficial to peripheral banks, if they are able to fund at negative rates in TLTROs. **This fragmentation makes monetary policy transmission through a single deposit rate instrument difficult in a negative rate environment, even while allowing banks to borrow at negative rates.**

These two challenges faced by the ECB are evident in the pressure on bank profits generally and growth of loans to companies in the periphery. While banking sectors with excess liquidity are mostly seeing the negative side of deposit rates, non-financial loan growth by banks in peripheral countries is not expanding, as shown previously.

The banking sector is fragmented, but sloshing with liquidity overall



Source: ECB

So, what should policy look like in Europe?

European banking sector profitability and the consequent organic capital generation are likely to remain under pressure in the near to medium term. Given our expectation of a growth slowdown in 2020, led by the US, heightened global geopolitical risk and transition at the top of ECB later this year, we believe bank investors need to tread with caution. While we don't think the direct impact of a more restrictive TLTRO III will be debilitating, possible constraints facing the ECB from a fragmented banking sector are concerning.

We think that for a banking sector with excess liquidity, a negative rate environment would likely constrain policy in the next downturn, raising questions about the efficacy of further rate cuts. If the ECB were to cut rates further, we would like to see a more aggressive tiering in deposit rates so that banks with excess liquidity are not penalised by rate cuts. Moreover, another round of TLTROs would make sense in such a scenario, with possibly easier conditions. Lastly, not all carry trades are the same. The typical carry trades that the ECB wants to discourage do increase the linkage between the governments and banks (so called 'doom loop' by some). But we think this is primarily a function of lower risk weights assigned to government bonds. If banks perceive higher risks in expanding loans, holding low-risk, high-quality corporate bonds in carry trades may even organically boost capital cushions and bring down borrowing costs for corporates. It may be better to restrict the payouts of carry trades, so that they are retained to boost capital, rather than restricting them altogether.

While getting the policy mix right to support the banking sector is crucial in order to boost the Eurozone's growth and inflation prospects more generally, it is also vital that the ECB acts aggressively to lift inflation expectations by engaging in more targeted monetary stimulus, which we think should be focussed on more asset purchases, commonly called quantitative easing (QE), along with fiscal policy playing its part to support Eurozone growth.

In terms of more QE, a credible commitment to expand the ECB's balance sheet is needed. In particular, a clear indication that the ECB will lift its self-imposed 33% of issuer limit on bond purchases would help additional bond purchases make the most market impact. **The ECB should also consider showing flexibility with respect to its self-imposed capital key limit as well, which restricts the mix of government bonds it buys, as this will compress spreads in the periphery while not pushing bund yields into more negative territory.**

In terms of fiscal policy, governments that have the fiscal capacity to spend more should do so, especially on investment, in order to boost growth and inflation in the Eurozone and avert downside risks.

In summary, a combination of monetary easing, a fiscal spending boost, and measures targeted at the banking sector are all needed in order to help the Eurozone now and make it more resilient to future shocks.

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