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The Poor Chances Of The ECB TLTRO II Lending Program Succeeding

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After the benign feedback of international markets to the ECB's new asset purchase program, the banking system is again under pressure in all of Europe. Not surprisingly, the most stressed banks are in Italy, where the problem of €200bn of bad loans is anything but under control. A new string of painful recapitalizations is looming and this is not good news for those who hope for a restart of credit to the real economy. Italy in March remains at the stake in terms of growth of loans to enterprises (+0.1% on a yearly basis), even if it's out-performing Greece (-1%), Spain (-1.2%), and Portugal (-2.2%).

The new, targeted loans (TLTRO II) should allow the banks to obtain long-term funding (4-year maturity) at zero cost. Moreover, there's the opportunity to obtain a negative rate, one that corresponds to a retroactive discount on the sum to be reimbursed, up to a maximum of -0.4%. This discount would apply only if the banks were to achieve some targets of increased loans to the real economy. The ECB's requirements are overall not that demanding. Even in the case where a bank is reducing its lending activity, it'll be enough to slow down deleveraging in order to benefit from the negative rate.

Many doubts arise about the potential size of the program. The TLTRO I program reached €428bn from its launch in September 2014, with the Italian banks getting the lion's share (over €103bn). The loans should be paid back during 2018. It's interesting to note that the last auction in March has been deserted with only €7bn requested; the Eurozone banking system has preferred to wait for the new TLTROs II given their lower cost (0% interest instead of 0.05%).

According to the criteria released by the ECB, the maximum amount of loans that can be drawn should be calculated on the basis of the pre-existing portfolio of loans to the Eurozone non-financial sector. This condition would reduce substantially the first optimistic estimates (over €1.5 trillion) that have circulated weeks ago (taking into account also the non-Eurozone private sector).

By extrapolating from the BIS data on banks' lending to Eurozone companies and from the National Central Banks' databases, it would be prudent to reassess the maximum potential size of the program as around €500-600bn.

A second question concerns the effectiveness of the proposed measure. By evaluating the poor performance of existing TLTROs and their predecessor facilities in terms of expanding credit via the bank-lending channel, we fear that very little of the eventual €600bn will reach the real economy.

From September 2016 the old TLTROs I will gradually reach maturity; it has to be expected that Eurozone banks will substitute as soon as possible the existing loans with the more convenient and long-term TLTROs II: a pure financial transaction that should lower the banks' overall funding costs by at least €2bn.

Therefore, €200bn could theoretically be put to use to increase lending. However, in 2017-2018 over €400bn of bank bonds will have to be reimbursed. Given the ultra-low interest rate environment and market turmoil ignited by the recent bail-in regulation, it's highly plausible that banks will renounce issuing new debt and will retain instead the ECB liquidity to further lower their funding costs. Moreover, it's the same ECB that is encouraging this behavior: while the old LTRO was supposed to be transferred to companies and households under penalty of restitution, now the ECB has lifted this rule and the banks can freely retain the borrowed sums until 2021 without any constraints.

Pragmatically, it's reasonable to forecast that the Eurozone banking system will do the bare minimum to satisfy the ECB criteria regarding loans growth (or, rather, about slowing the decline in lending). In this way Eurozone banks could both obtain a discount and retain the resources to improve their profitability ratios. Eventually, it appears that, at a second glance, the new ECB measures are designed to recycle liquidity into the financial system, by encouraging mainly operations that can be traced to mere asset-liability management.

In my opinion, the ECB ABS asset purchase program remains the most effective channel to reach the real economy, but we have to acknowledge that it's practically been on hold since inception. In the case of Italy, a properly engineered bad bank at national level could free the banks of most of the bad loans mixed with a fair share of good loans. Then the bad bank should issue ABS partially guaranteed by the government and should sell them to the ECB. The scale of this program for the entire Eurozone should be adequate to the task of reducing the burden of bad loans in the most distressed countries (Italy, Spain and Greece) at a physiological level: this means at least €350bn of ABS purchases, ten times the current purchased amount. This tool, that I've proposed in a research published with the think-thank ASTRID some time ago, could work in synergy with a special purpose vehicle dedicated to the banks' recapitalization in the perspective of re-igniting the credit cycle. It's somewhat comforting to know that similar solutions are under discussion by Euro area governments, albeit only at a national level.

In conclusion, the announced ECB measures cannot work in time. Tackling deflation effectively should necessarily involve more unconventional – even radical – policies. In principle, the idea of a money paradrop ('helicopter money') to revive investment, maybe in the form of monetary financing of a supranational entity like the European Investment Bank, cannot (and should not) be ruled out.