Economist Insights

Finally a Lending Stimulus

The ECB announced the Targeted Long-Term Refinancing Operation (TLTRO) in June as one of its measures to stimulate lending. The TLTRO is very similar to the Bank of England's Funding for Lending Scheme (FLS), although the TLTRO's terms are actually more advantageous for banks than those of the FLS. It looks like the ECB has tried to learn from the Bank of England's experience, but it will take some time for TLTRO to have a discernable impact.

Joshua McCallum
Head of Fixed Income Economics
UBS Global Asset Management
joshua.mccallum@ubs.com

Gianluca Moretti
Fixed Income Economist
UBS Global Asset Management
gianluca.moretti@ubs.com

This may come as a surprise to some, but the central bank does not control interest rates. It controls at most two interest rates: the rate that the central bank pays when it borrows and the rate that it charges to lend. For the rest, central bankers just have to hope that changes in their own interest rates translate into changes in the rates that really matter for the economy. This has become a lot harder since the crisis. For example, the European Central Bank (ECB) refinancing rate is just 0.15%, but the bank business lending rate is 2.62%, a spread of 247 basis points. Back in 2007 that spread was just 118 basis points. The transmission mechanism from central bank rates to the rest of the economy looks pretty broken.

To try to correct this break in the transmission mechanism between central banks and the rest of the economy, the ECB announced a series of measures in June. The hope is that these measures will stimulate lending, which in turn should help counter the threat of deflation. The most important of these measures goes by the rather unwieldy name of the Targeted Long-Term Refinancing Operation (TLTRO).

The ECB will be providing cheap loans to the banks for four years, up to September 2018, as long as the banks use these funds to support lending to the private sector (other than mortgages). A nice idea, but this kind of scheme faces two main challenges. The first is to get the banks to actually participate in the program. Those familiar with the Bank of England's Funding for Lending Scheme (FLS) will know of its very low participation rate. The second challenge is to guarantee that those banks that do participate will actually channel those funds to the private sector instead of buying government bonds.

Like the FLS, the TLTRO is divided into two stages. In the first stage, banks will be allowed to borrow as much as 7% of their loan book (excluding mortgages) in two operations that will take place in September and December. In the second stage, from March of next year, banks will be allowed additional borrowing on a quarterly basis but only if they increase their eligible lending relative to a benchmark.

Despite the similarities, the TLTRO looks much more advantageous than the FLS (chart 1). The first phase is larger in the TLTRO, offering 7% rather than 5%. The borrowing costs banks face are also lower, making the effective subsidy larger. The second phase is also more generous: for each additional euro above benchmark that a bank lends out, the bank will be able to borrow three additional euros.

Chart 1: Easier than thou

Comparison of FLS and TLTRO

	BoE FLS	ECB TLTRO
Initial take up	5% of existing loans to non-financial corporations and households	7% of existing loans to non-financial corporations and households ex-mortages
Funding cost	T-bill repo rate +0.25 bp	MRO rate +10 bp
Additional take up	1 GBP for each GBP of new lending	3 EUR for each EUR of incremental lending relative to a benchmark
Penalty	25 bp for each 1% decrease in lending	Early repayment in Sept 2016

Source: UBS Global AM. The table refers to the original version of the FLS as announced on 13 July 2012 and does not account for the subsequent modifications made on 24 April 2013.

The threshold that banks have to achieve to have 'increased lending' will also be lower under the TLTRO. To remain in the scheme, banks that have been expanding their loan book in the year to April 2014 will only have to keep their loan book unchanged. Banks that have been shrinking their loan book will still be allowed to reduce their lending for one more year, as long as they reduce it at a more moderate pace. After that they will no longer be allowed to reduce their lending to qualify (but could just keep it flat).

The most important incentive to join the TLTRO probably comes from the absence of any tangible penalties. Participating banks that do not respect the benchmark will only face a requirement to repay the loan two years earlier, in September 2016. In contrast, under the FLS a penalty of an extra 25 basis points for each 1% of reduction in total lending was put in place. So banks may as well join the TLTRO, even if they are not sure whether they will be able to lend enough to meet the benchmark. The worst that happens is that they get cheap funding for two years rather than four years.

This brings us to the second question: will the additional funds find their way to the private sector or will they simply end up in government bonds? The ECB's first two Long-Term Refinancing Operations not only ended up supporting sovereign bonds but also ended up crowding out lending to the private sector by encouraging banks to accumulate more sovereign bonds.

The answer is likely to be yes, but not in the form that markets are expecting. Increased lending to the private sector is not the correct criteria for judging the success of the TLTRO. The TLTRO, and especially the first phase, is not really designed to incentivise additional lending, but rather to reduce the cost of funding for banks which in turn will (hopefully) reduce the borrowing costs for the private sector.

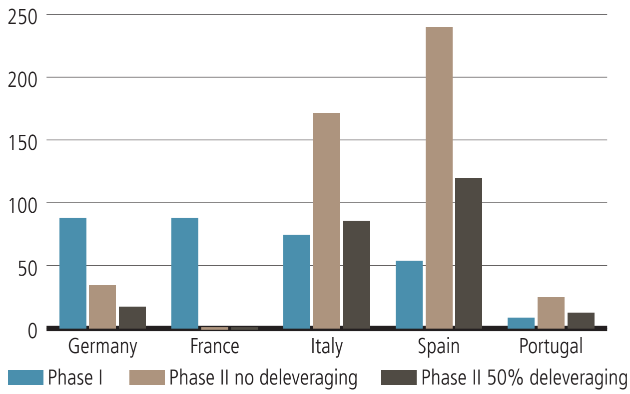
During the sovereign crisis, the cost to periphery banks of raising funds increased sharply and remained elevated (see *Economist Insights*, 22 April 2014). This directly translated into higher borrowing costs for the private sector, making any policy easing from the ECB largely ineffective in the periphery. Most of the loans to non-financial corporations are short dated (up to one year) and funded by banks through short-term borrowing. It is quite likely that in the first stage banks will simply roll over maturing loans into the TLTRO. It should not be a surprise if most of the take up will be concentrated in the periphery.

The real incentives for banks to increase (or stop decreasing) lending to the private sector will kick in during the second phase. In the year to April 2014, lending to the non-financial private sector (ex-mortgages) shrank in most European countries. The most aggressive reductions were in Spain and Italy where banks cut their lending by around EUR 80 bn and EUR 60 bn, respectively. However, loans also shrank in Germany and Portugal (by around EUR 10 bn). French banks were the only ones to have expanded their loan books.

The second phase of the TLTRO will allow a bank that significantly cut lending over the reference period to borrow a very large amount of cheap liquidity as long as it keeps its level of loans unchanged or simply deleverages at a slower pace. If they keep their eligible lending unchanged, Italian and Spanish banks will be allowed an additional borrowing of EUR 170 bn and EUR 240 bn, respectively (see chart 1). If they decide to continue deleveraging, but do so at half the pace, they will be allowed to borrow half that amount.

Chart 2: In for a cent, out with a euro

Potential take up assuming maximum borrowing in the first phase of TLTRO and no deleveraging in 2015



Source: ECB, UBS Global Asset Management

To put it differently, even if banks do not expand their total eligible lending next year, they will be able to refinance a large part of their loan book at a very cheap rate. This is likely to push borrowing costs for the private sector even lower. A lower borrowing cost in the periphery could incentivise demand for credit which banks would be able to satisfy by borrowing from the ECB at a very convenient rate.

It is still possible that some of the TLTRO borrowing will be used to buy government bonds. Regulatory requirements still mean that banks have to hold a lot of government bonds. However, if a bank uses the funding to buy government bonds and therefore has to pay the funding back early, the very low yield on 2-year government bonds will make this unattractive even taking into account the cheap funding from the TLTRO.

The ECB has clearly looked closely at the FLS and decided to learn from the Bank of England's experience. Nonetheless, it will take some time for the TLTRO to have a discernable impact on the economy; not least because it does not even start until September. The biggest risk, however, is that waiting to see how the TLTRO does will be used as an excuse for the ECB to avoid further measures, such as outright quantitative easing. If it turns out that the TLTRO is not enough, then quantitative easing may come too late.