

Focal Point

New ECB measures: A mixed bag for banks

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- On March 10, the ECB provided a bold package of new monetary policy measures.
- It lowered the deposit rate to -0.4%, extended its monthly purchases under the asset purchase program (APP) to € 80 bn, and made non-financial corporate bonds eligible for the latter. It also announced a new, more generous Target Longer-Term Refinancing Operation (TLTRO II) program.
- While negative deposit rates and a flat yield curve will weigh on banks' profits, the TLTRO II will provide redistribution effects among euro area banks and will buy time to fix capital shortfalls, thus easing systemic risk concerns.
- Indeed, peripheral banks will benefit the most from TLTRO II. Cheap liquidity can be used either for loans generation, carry trade activities or for easing funding strains.
- Greek banks will have to wait for the completion of the first review of the third bailout program and the reinstatement of the ECB waiver to fully exploit the benefits of ECB asset purchases and the TLTRO II.

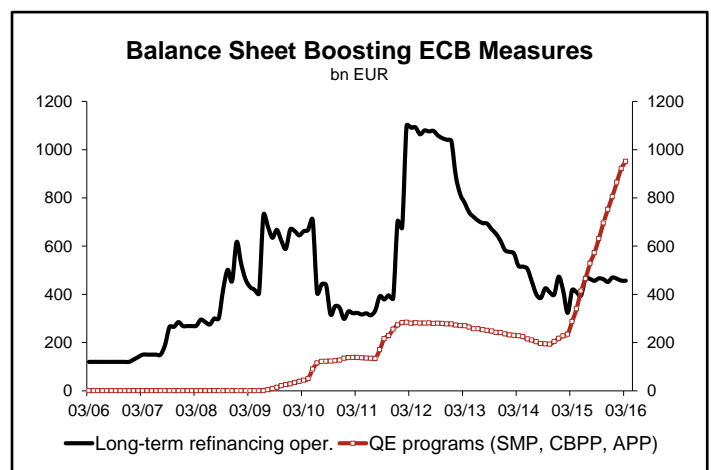
Monetary policy has come back into the focus of markets. On the one hand, markets have started to increasingly question its effectiveness over the foregone months and expressed concerns about the negative side effects on the banking sector. On the other hand, the surprisingly bold ECB measures announced on March 10 contributed to a better market sentiment again. In what follows, we assess the latest ECB policy measures with reference to its impact on the banking sector.

TLTROs almost a free lunch for banks

At its March meeting the ECB announced further bold policy measures. It lowered the repo rate to 0.00% (from +0.05%) and pushed the deposit rate further into negative, to -0.4% (from -0.3% before). Additionally, the quantitative easing measures were strengthened. The volume of monthly purchases under the APP was increased to € 80 bn (from € 60 bn before) and non-financial corporate bonds were made eligible for the APP. By extending its purchases to corporate bonds, the ECB went one step further into uncharted QE territory.

Moreover, the ECB made use of longer-term refinancing operations again, in an attempt to stimulate credit activity. It announced four new quarterly TLTRO IIs, starting at the end of the second quarter 2016. These TLTRO IIs are much more attractive for banks than their predecessors for three key reasons: First and most importantly, there is no provision forcing banks to early reimbursement in case of missed loan targets. Previously, banks were obliged to turn back funds after two years should they fail to achieve the minimum loan target. Second, the potential amount

that can be borrowed by banks was increased from 7% to 30% of the outstanding level of loans (as of January 2016) to non-financial corporations and households excluding loans for house purchase. This means that potentially nearly €1.5 trillion will be available for TLTRO II or €1.1 trillion in terms of additional funding. Third, participating banks will pay no interest on this lending (the maximum cost is the main refinancing rate) and they will have the opportunity to even be paid to borrow. The funding cost can indeed fall as low as the deposit rate at the time of take-up should the bank beat its benchmark lending target by more than 2.5%.



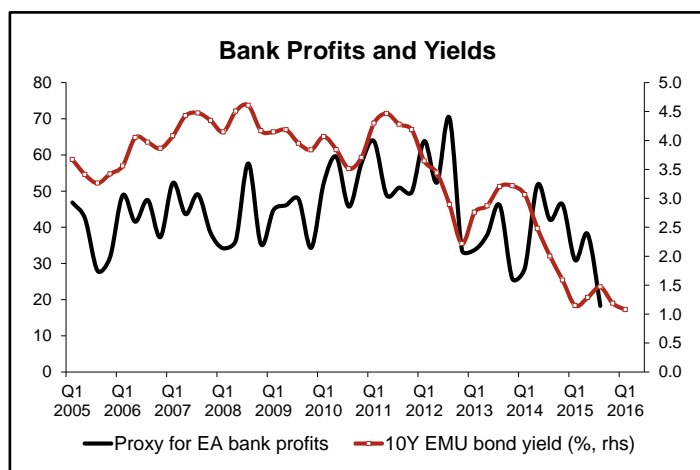
These measures will be very powerful in boosting the ECB's balance sheet. The increase in purchases under the APP will sum up to € 240 bn until March 2017 so that

overall purchases will be € 1740 bn at that date. The take-up of TLTRO IIs will complement the balance sheet expansion. Apart from the likely switch of most of the existing TLTROs into the new ones, given the attractive conditions, the perspective of negative interest will likely boost demand for ECB funding strongly. From the perspective of a bank, the new TLTROs are almost a free lunch so that the take up could really be sizeable. As a result, the ECB's balance sheet will most likely exceed the threshold of € 4000 bn by Q1 2017.

Low rates and flat yield curve hurt banks

While the TLTRO II constitutes definitely a significant easing of banks financing conditions, the overall effect of the present ECB monetary policy stance on bank profitability is less clear. With the further significant reduction of government bond yields since 2014, the lending rates for banks were also reduced. Because monetary policy had almost reached the lower bound of the conventional policy rate, the flattening of the yield curve aggravated the pressure on bank profits. These considerations also contributed to the latest market concerns about the effectiveness of monetary policy and the stability, as well as profitability of the banking sector.

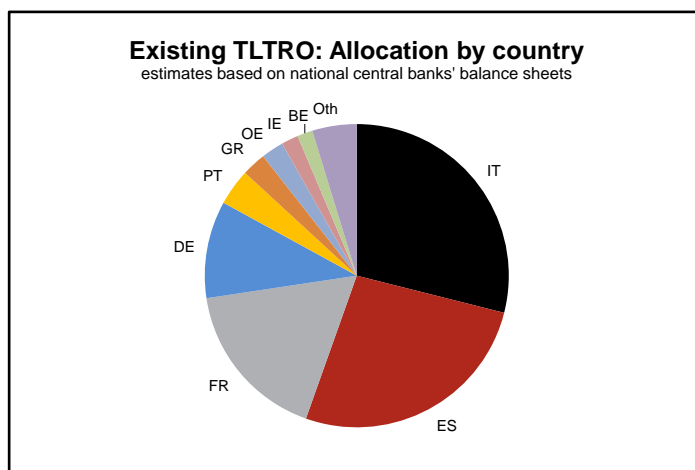
In the press conference following the March meeting, however, the ECB defended its measures and argued that lower funding costs and capital gains on banks assets, due to the downshift of the yield curve, contributed to higher returns on equity of euro area banks. Moreover, the ECB argued that impairment costs have been reduced due to the monetary policy induced continuation of the recovery. That said, the ECB also acknowledged that banks are differently affected by its policy measures. Banks in countries where laws set a minimum bound for deposits and banks, which have given mortgages and loans indexed to the Euribor, inevitably suffer.



Seen from this perspective, the TLTRO II mitigates, at least partly, the adverse impact of negative rates on banks' profitability. Moreover, the ECB communicated very clearly that a further cut in the deposit rate into even deeper negative territory is not on the cards. The TLTRO II facilitates funding concerns especially for weaker banks and thereby contributes also to a higher degree of financial sector stability and lower systemic risk. Therefore, the latest monetary policy package has the potential to improve the negative sentiment on the banking sector at the margin.

Southern European banks to benefit the most

Likewise its predecessor, TLTRO II will be particularly helpful for Southern European banks. In the previous experience, the total take-up of ECB funding totaled almost € 418 bn, split along the quarterly six operations conducted between September 2014 and December 2015. Unsurprisingly, the biggest beneficiaries have been Italian and Spanish banks, which jointly accounted for nearly 55% of the total funds tapped by credit institutions. On the other hand, German banks have limited their take-up to just above 10% of the total, despite their eligible quota (based on loans to non-financial corporations and households excluding mortgages), which exceeded 23%.



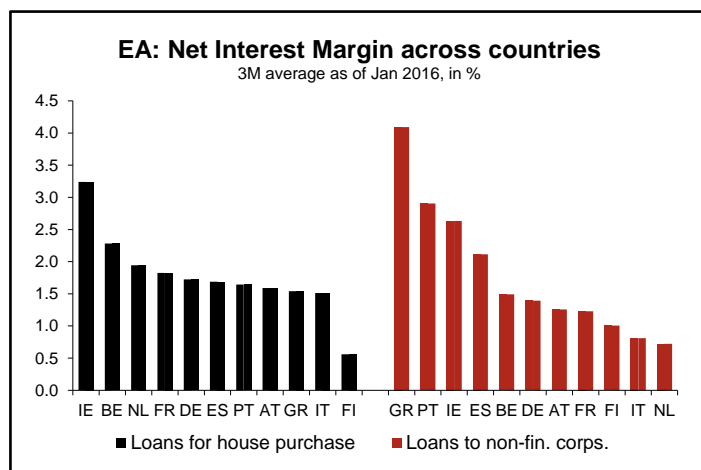
We expect Southern European banks to continue dominating in terms of participation to the four quarterly TLTRO II to be conducted from June 2016. Indeed, the revised design is much more favorable than before, as outlined above. The lack of conditionality (banks are only required to post the necessary collateral against their borrowing needs) allows financial institutions to pursue different strategies. The first option is, obviously, new lending activity. With the notable exception of Italian names, banks operating in peripheral countries still enjoy an interesting net interest margin (NIM) on new business despite the flattening of the yield curve. Consequently, TLTRO II can support new loan generation, or at least soften the deleveraging process and support banks' profits via higher volumes.

A possible alternative is to pursue carry trade activities. The yields of 5-year peripheral bonds – a maturity that matches the expiration of the last TLTRO II in March 2021 – still offer positive returns, ranging from 30-40 bps in Italy and Spain to 1.8% in Portugal that compares to a 0% funding cost.

Furthermore, some mid-cap banks under financial stress can benefit from TLTRO II by substituting expensive funding with the cheaper, 4-year long money from the ECB. While this does not represent a long-term solution, in case of an insufficient capital position (a strong impediment to the full recognition and disposal of non-performing loans in weaker countries like Italy), it buys time to fix the latter issue and will contribute to reduce market woes on the solidity of the financial system in the euro area.

All in all, the latest ECB package will also contribute to a better market sentiment regarding banks. The risk of tail events emanating from distressed banks has been reduced. This, coupled with very low price book levels relatively to the broader equity index (only experienced in

2009 and 2012), could induce some short-term relief for the sector. On a longer-term perspective, however, the continuing pressure from subdued nominal GDP growth and low yields on profitability and a still tough regulatory environment will cap the upside potential.

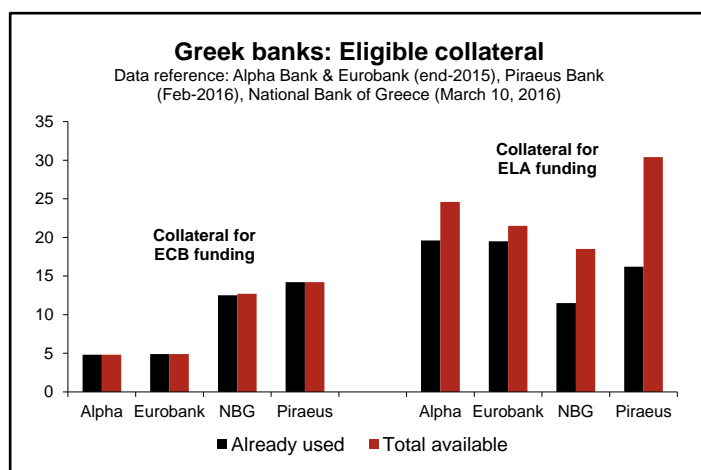


more convenient TLTRO II. Also, part of the Main Refinancing Operations funding (€ 24.1 bn in January), which has a much shorter maturity, could be switched to the TLTRO II as well, but will not provide any advantage in terms of cost of funding. Moreover, the extent of such an operation is heavily dependent on the maturity of the existing ECB-eligible collateral, thus limiting the potential benefits for Greek banks. As already mentioned above, the more crucial switch of the expensive ELA (which carries a cost of 1.50% bps) into zero-cost ECB's liquidity, remains impractical at this stage.

Greek banks on hold for now

While Greek banks prices have almost doubled since the market trough in February, they are still down by 26% year-to-date. Indeed, the concerns over the liquidity position – Greek banks remain heavily dependent on Emergency Liquidity Assistance (ELA), with the ceiling still at € 71.4 bn – and new deposit outflows registered in January weighed considerably on equity performance.

The measures announced by the ECB last week will represent a positive factor for Greek banks in the medium-term. That said, at the current stage they cannot exploit in full the benefits of ECB action. First, Greek government bonds are still excluded from the Public Sector Purchase Program (PSPP). Second, Hellenic banks will not be able to increase their TLTRO funding in a meaningful way due to the lack of eligible collateral following the suspension of the ECB waiver in February 2015. The latter will not be reinstated until the first review of the third bailout program is completed. While we are constructive on a final positive outcome of the review, the timing remains highly uncertain. The difficulty in finding a compromise between PM Tsipras' government and the Troika on some key aspects (e.g. a new pension reform involving additional cuts) could still significantly delay this process.



In the meanwhile, Greek banks can switch their TLTRO position (€12 bn including 3-month operations) into the

Imprint

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