TLTROs: Mario Draghi's last ECB move?

Italian banks hope for a third round within June

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Preface

Just **a few words pronounced by Benoit Coeure** on February 15 in New York, at an event organized by the Council on Foreign Relations, have been enough to trigger a **jump in the FTSE MIB** - mainly driven by the banking sector - and a sudden **shrinkage in the spread** between Italian BTPs and German Bunds.

The statements of the member of the Executive Board of the ECB were about the **deeper-than-expected economic slowdown** in the euro area and a new **TLTRO program as a "*possible*" response** to the phenomenon.

The theme of a **third round of Targeted Longer-Term Refinancing Operations**, already the subject of thoughts during the last months of 2018, has become, with the beginning of the new year, one of the main topics of monetary policy in the euro area as well as a **new subject of confrontation** between hawks and doves **within the Governing Council of the ECB**.

Indeed, the **end of Quantitative Easing** at the beginning of 2019, the publication of **not encouraging macroeconomic data** for the near future of the European economy, and the approaching of the **maturity of the previous tranches** of extraordinary targeted loans, have awakened the interest of investors and policymakers about a possible new round of TLTROs.

On February 20, **the Chief Economist of the ECB**, **Peter Praet**, spoke on the matter, confirming that "***the discussion [about TLTROs] will come very soon in the Governing Council***" even though it doesn't mean that a decision will be taken at the **next meeting in March**, when updated (likely reduced) estimates on growth and inflation will be released.

In fact, opinions within the Governing Council are expected anything but unanimous. The statements by Coeure and Praet were followed by the words of **Ewald Nowotny** – governor of the Austrian central bank and supporter of Jens Weidmann as the next president of the ECB – which on February 21 **declared to see "*no need for further liquidity*"**.

But let's take one thing at a time ...

TLTRO I

Since 2009, the ECB has remarkably expanded its range of **monetary policy instruments**, sometimes introducing **new measures**, such as the **Asset Purchase Program** (APP), sometimes remodeling existing measures.

In this context, they were launched two **Longer-Term Refinancing Operations** with a tenor of **three years** (i.e. longer than the three months maturity of regular LTROs) and two rounds of **Targeted Longer-Term Refinancing Operations** (TLTROs).

Key ECB interest rates

Deposit Facility	**-0.40**
MROs	**0.00**
Marg. Lending Facility	**0.25**

Source: ECB

Next monetary policy meetings of the Governing Council of the ECB

March 7, 2019

April 10, 2019

June 6, 2019

July 25, 2019

September 12, 2019

October 24, 2019

December 12, 2019

Source: ECB

Executive Board members: terms of office

May 31, 2019
Peter Praet
(Chief Economist)

October 31, 2019
Mario Draghi
(President)

December 31, 2019
Benoit Coeure
(In charge of Market Operations)

December 14, 2020
Yves Mersch
(In charge of Risk Management)

January 26, 2022
Sabine Lautenschlager
(In charge of Statistics)

May 31, 2026
Luis de Guindos
(Vice-President)

Source: ECB

The first series of TLTROs **was announced on June 5, 2014** and consisted of **eight auctions**. The operation was introduced by the ECB as "aimed at **improving bank lending to** the euro area **non-financial private sector**, excluding loans to households for house purchase".

For TLTRO I it was initially announced an **interest rate equal to that on Main Refinancing Operations** (MROs) **plus** a fixed spread of **10 basis points**. Following the completion of the first two auctions, on January 22, 2015, the ECB decided to remove this spread for the remaining six transactions.

TLTRO II

€739bn of funding across 4 tranches at virtually negative interest rates

The second round of TLTROs **was announced on March 10, 2016** and was divided into **four quarterly auctions**, from June 2016 to March 2017. The maturity of the refinancing was set at **four years**, with the possibility of **early repayment after two years**.

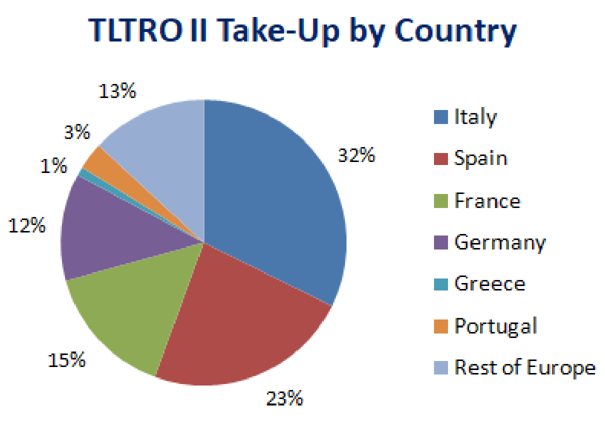
The **incentivizing mechanism** developed by the ECB provides that the amount of funding obtainable by each bank can be equal to **a maximum of 30% of its loans** to households and non-financial firms. As a consequence, the greater it is the amount of loans to the real economy made by a bank, the greater it can be its collection of funds from the ECB.

In addition, the very same **fixed interest rate** applied to refinancing operations (equal to that of MROs, i.e. zero) **can be reduced until it reaches** the negative rate on overnight deposits (**-0.40%**) if the bank increases its financing to the real economy **above a given benchmark**.

Through the four windows of the TLTRO II, euro area banks have raised a total of **€739bn**.

Taking into account early repayments, **the restitution of the remaining TLTRO II funds** (**over €720bn**) **will take place according to the following schedule**:

- June 2020: €382bn;
- September 2020: €44bn;
- December 2020: €62bn;
- March 2021: €233bn.



Source: Bloomberg

TLTRO III?

A third – less generous – round could start within June

Some analysts expected the announcement of a new round of TLTRO already on the **December 2018 ECB Governing Council meeting**, also due to the end of net asset purchases since the beginning of the new year.

The expectation has been disappointed on that occasion and also on the following one, in January, **but weaker-than-expected economic data** released by European statistical institutes in the first few weeks of 2019 **have increased the likelihood of an announcement at the March meeting** (or at worst in April).

According to several observers, the weak but relatively more prosperous European economic environment compared to that of the two previous refinancing periods, lets it forecast a **less generous TLTRO than previous ones**, i.e. characterized by **shorter maturities** (two or three years) and by a **floating interest rate** (indexed to the rate on MROs).

NSFR

The end of TLTROs could harm banks' liquidity requirements

Starting from **June 2019**, a substantial part of TLTRO II funds received by European banks from the ECB will slide from bucket to bucket according to the mechanic [*] of the **Net Stable Funding Ratio** (NSFR), the liquidity requirement aimed at ensuring that each bank has an adequate volume of stable liabilities in relation to the composition of its assets.

This shift will create a **huge need for liquidity by European banks**. This liquidity should be collected by banks **a year in advance** of the effective date of repayment of TLTRO funds to the ECB (which will not take place until June 2020, unless the bank resorts to the windows of early repayment).

This is why it is within June 2019 that observers expect the ECB to launch **TLTRO III**. The alternative scenario (to be avoided) would be that of a **substantial and synchronized demand for funds** by banks on European markets, with a consequent **rise in borrowing costs** and a subsequent increase in lending interest rates, with the effect of further slowing down the already weak European economic situation.

Italian banks

Italian lenders have the largest TLTRO exposure

With around **€240bn of maturing funds** (about 1/3 of the total) and an incidence above 6% of total assets at the end of 2018, Italian lenders are the ones that **have drawn the most on TLTROs** and are therefore the most exposed to the next moves by the ECB (positively in case of renewal of the operation and negatively otherwise). This is also due to **structural features** of the Italian banking sector, such as the presence of **many small- and medium-sized banks**, which are more exposed to potential funding difficulties in the event of a negative decision on TLTRO III.

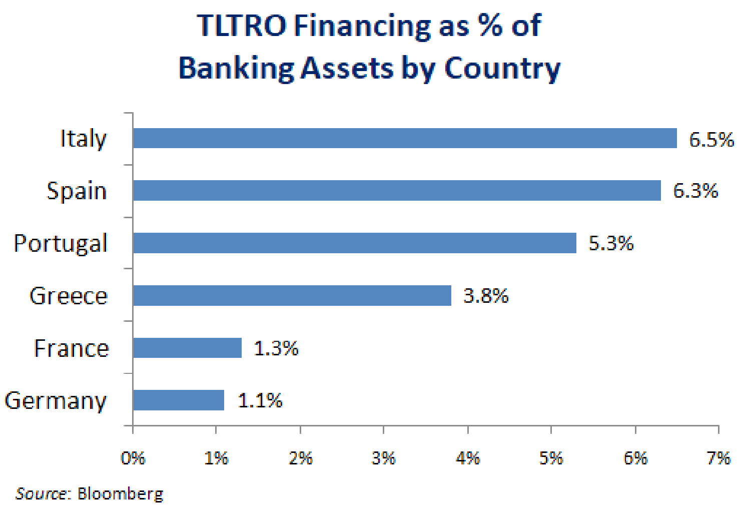
Statements by Italian bankers suggest that **a third tranche** of ECB funds **would certainly be welcome** but the Italian banking system would also be **able to bear a non-renewal**.

For example, this is the point of view of the **President of the Italian Banking Association**, **Antonio Patuelli**, according to which Italian banks are "*attentive and well supervised, therefore **well prepared for liquidity repayment deadlines***", adding that he doesn't expect that "*as the deadline is approaching, they would revoke loans to obtain liquidity*".

[*] The value of Available Stable Funding (ASF) for each bank (the numerator of the NSFR) is calculated by weighting the value of each source of funding with a different coefficient (ASF Factor) depending on the category to which the liability belongs. For example, liabilities with residual maturity equal to or greater than one year have a full weighting (100%) while funding (including that collected at a central bank) with residual maturity between six months and one year is weighted only at 50% (and at 0% under six months), thus contributing to a lesser extent to the calculation of the ASF.

More direct comments have been expressed by **Giuseppe Castagna, CEO of Banco BPM** ("*surely we would be pleased*") and by **Stefania Bariatti, Chairman of Monte dei Paschi di Siena**, who described as "*certainly positive*" the prospect of a renewal. On the other hand, the **CEO of Banca Ifis, Giovanni Bossi**, has said that, even if TLTRO auctions are not renewed, its bank could "*easily*" refinance its debt.

The expectation (or perhaps the hope) of Italian financiers is, however, almost one-way: during the **Assiom Forex Congress** in Rome in early February, **78% of the practitioners** surveyed by the italian newspaper Il Sole 24 Ore have said they were **convinced that** in 2019 **the ECB will re-propose TLTRO auctions**.



Conclusions

The minutes of the last meeting of the Governing Council of the ECB (**January 23-24**) revealed that "*while any decisions in this respect [TLTROs] should not be taken too hastily, **the technical analyses required to prepare policy options for future liquidity operations needed to proceed swiftly***".

Mario Draghi himself, during the press conference on January 24, **has used prudent words**, highlighting the usefulness of the previous targeted refinancing operations, but specifying that **any future TLTRO must be motivated by general monetary policy aims** and not by the need to support the banking industry of one or more countries in particular.

Given the **lower and lower probability of a rate hike before the end of 2019**, the decision to launch a TLTRO III could be **the last act** of **Mario Draghi** at the helm of the ECB. Indeed, the Italian central banker **will conclude his mandate on October 31, 2019**.

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