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TLTROs: here to stay?

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TLTRO III have played a crucial role during the Covid-19 pandemic. The easing of their terms by the ECB has led to the injection of EUR 2,200bn into the banking system, allowing the latter to accommodate without tightening financing conditions the large-scale increase in the liquidity needs of economic agents. As the ECB prepares to recalibrate its monetary policy instruments, there are several arguments supporting new TLTROs. The central bank is likely willing to avoid a sudden tightening of financing conditions for the economy and should recalibrate TLTROs accordingly to encourage a smooth normalisation of liquidity conditions.

From transition to crisis management

Launched by the ECB in September 2019, with the aim of smoothing the repayment of TLTRO II, TLTRO III was initially designed as a tool to accompany the transition to a normalised bank liquidity outstanding. Their initially unattractive terms[1] made them primarily an instrument of last resort for banks to diversify their sources of long-term financing.

However, with the emergence of the Covid-19 pandemic a few months later, the ECB transformed TLTRO III into a crucial instrument of its crisis management. The decisions of March, April and December 2020 of the Governing Council significantly increased the amounts of the borrowing allowance (from 30 to 55% of the eligible[2]loan book), lowered the interest rate of operations to -1% between June 2020 and June 2022 and reduced the lending benchmarks to be awarded this rate. These decisions also broadened the range of eligible assets[3] to collateralise borrowed liquidity and

[1]*The TLTRO III.1 in September 2019 attracted only a participation of EUR 3.4bn, the smallest amount allocated since the creation of the TLTROs in 2014.*

[2] *Loans to non-financial corporations and households, excluding housing loans.*

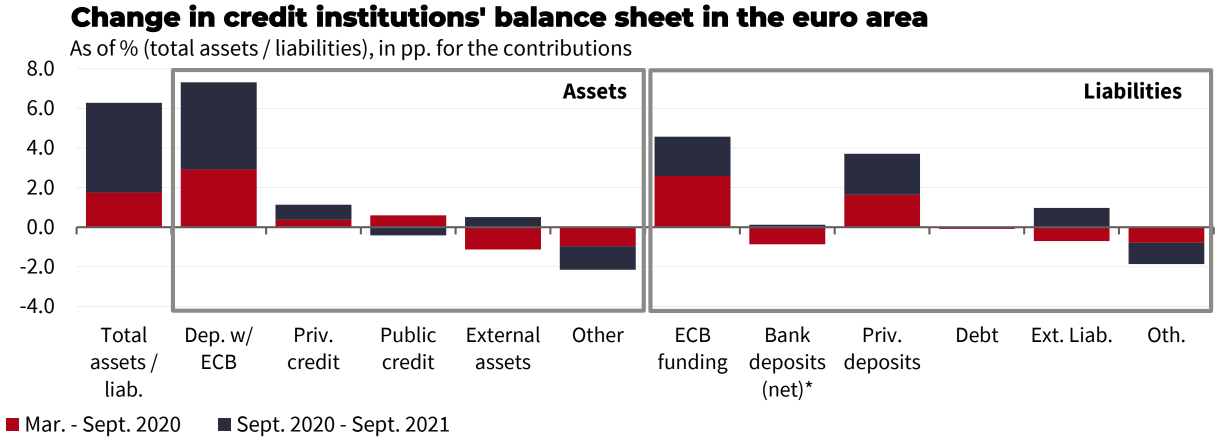
[3] *Five measures eased the ECB's collateral framework. First, the eligibility of additional credit claims (non-negotiable claims, often bank loans to a private agent) has been increased. Second, the ECB froze collaterals' ratings at their pre-pandemic level to prevent a downgrade from affecting their availability. Third, haircuts on collaterals have been reduced by 20% uniformly across different asset classes. Fourth, the maximum exposure to unsecured debt of the same bank issuer was increased from 2.5% to 10%. Finally, Greek sovereign bonds were made eligible for refinancing operations.*

increased the flexibility of banks' repayment options and participation in operations.[4] With the recalibration of TLTRO III, the ECB thus gave banks the leeway to be part of the solution and maintain very favourable financing conditions for businesses and households when liquidity needs rose sharply.

The result was an unprecedented injection of liquidity into the banking sector, with the TLTRO III outstanding reaching EUR 2,200 bn in September 2021, or around a third of the Eurosystem's open market operations (the rest being made up of asset purchase programmes). This is almost twice as much as the maximum outstanding amount reached during the euro area crisis.

How has borrowed liquidity been used by banks? Balance sheet data (**Chart 1**) show that TLTRO III enabled participating banks to meet the strong and urgent demand for credit to the private sector caused by the pandemic, both in the initial phase of the crisis and in the economic recovery phase. Purchases of public debt also increased initially, driven by government issuance. But net flows of purchases then turned negative, with banks favouring credit origination and issuance being largely absorbed by asset purchases of the central bank.

Chart 1 – TLTRO III contributed to increased credit to the private sector



*Source: ECB, Refinitiv Datastream, SG Economic and Sector Studies * Net of loans to monetary and financial institutions*

Participation in TLTRO III was accompanied by a sharp increase in deposits with the Eurosystem. It is a purely mechanical rise, as the borrowed liquidity (and that injected via asset purchases) evolves in the closed circuit of banks and does not decline when a loan is granted to a household or a firm, that are not part of this circuit.

[4] Initially, the amount that can be borrowed per operation was capped at 10% of the borrowing allowances. This limit was removed in March 2020. Then, banks have the possibility to repay the operations of June, September, and December 2021 from June 2022 if they wish, while the previous operations are only repayable from one year before their maturity.

On the liabilities side, the rise in Eurosystem funding also came with a sharp increase in private sector deposits, reflecting the constrained and precautionary savings during the pandemic. During the initial stage of the crisis, these offset a decline in interbank lending and funding from non-residents. Bond debt has remained stable over the period. Overall, at the sector level, the use of TLTROs does not seem to have had significant substitution effects on the liabilities of credit institutions (although situations at the level of individual institutions may vary).

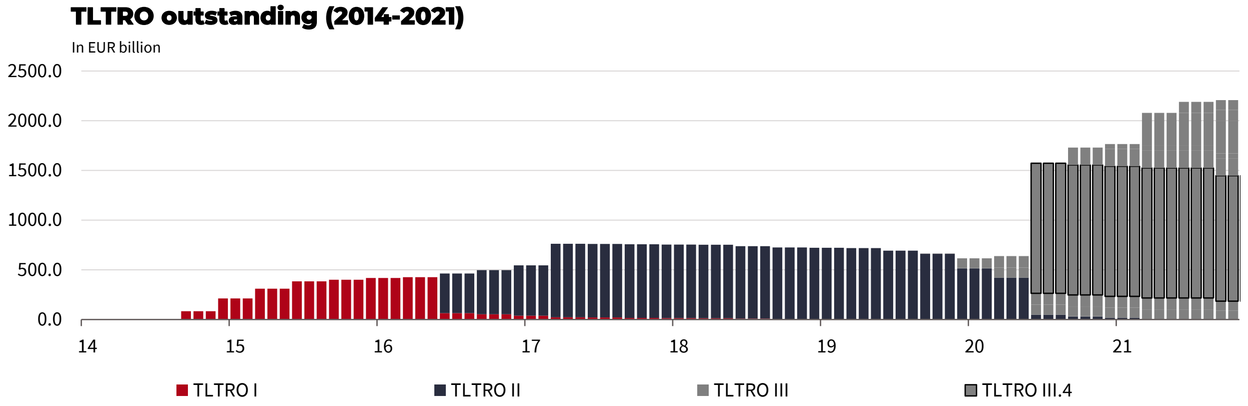
What future for TLTROs?

As the 10th and final TLTRO III takes place in December and the ECB recalibrates its monetary policy, the question of the future of TLTROs is once again under debate. Indeed, the central bank will soon be faced with the same situation as in 2019 with the TLTRO II: avoiding the risk of an excessive increase in the funding cost of banks, companies and households that would stem from a fast unwind of the instrument.

For some banks, first, the decline in the residual maturity of TLTROs could result in a financing need linked to the compliance requirement with the NSFR (Net Stable Funding Ratio)[5]. Indeed, as TLTROs provide stable funding for maturities above one year, they are 100% eligible for the NSFR. But in 2022, the residual maturity of the operations carried out in 2020 (amounting to EUR 1,650 bn, including EUR 1,300 bn for the June operation alone) will be less than one year, lowering the eligibility of these TLTROs to 50% (**Chart 2**). This would impact ratios if TLTROs are not replaced by other long-term financing, and if TLTROs themselves initially replaced long-term funding. In turn, banks then forced to adjust ratios would then tighten credit conditions to the real economy.

[5] *The NSFR (Net Stable Funding Ratio) is the amount of stable funding available in relation to the amount of stable funding required. This ratio should always be at least 100 %. "Stable available funding" refers to the share of equity and liabilities that is expected to be reliable for up to 1 year. The amount of "permanent funding required" of an institution depends on the liquidity characteristics and residual duration of the assets it holds and those of its off-balance sheet positions.*

Chart 2 - The TLTRO III.4 (June 2020) accounts for 57% of the total TLTRO outstanding



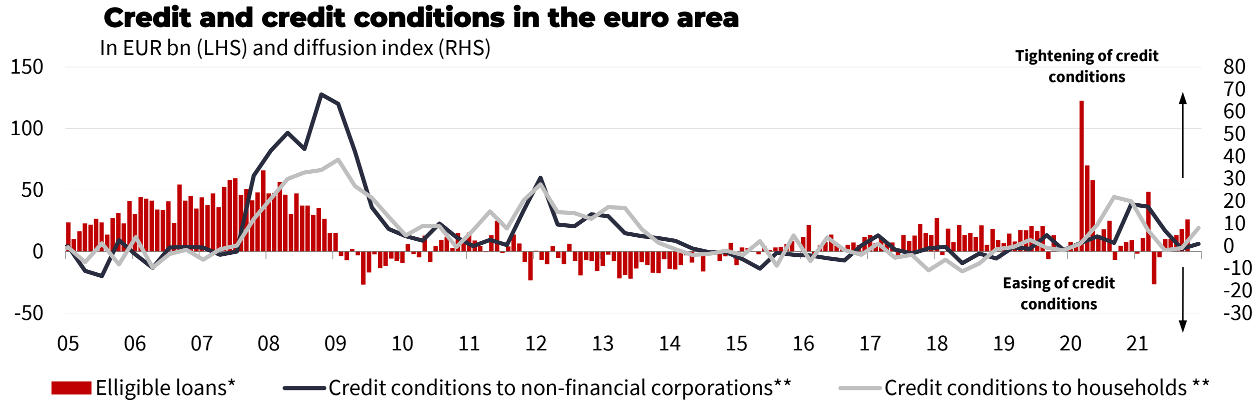
Source: ECB, Refinitiv Datastream, SG Economic and Sector Studies

On the household and business side, tighter credit conditions could also come from the end of the special interest rate period in June 2022. Indeed, this temporary modality of TLTRO III, which has been running since June 2020, has been a powerful incentive for banks to lend.

As a reminder, provided that the eligible loan book is stable, the participating banks "pay" during this special period -1% on the liquidity borrowed from the TLTROs, namely the deposit facility rate at -0.5% and a premium of -0.5%. Therefore, since the amount borrowed and mechanically redeposited to the ECB is itself "remunerated" at the deposit facility rate, the premium overcompensates the effective cost of liquidity. And since being awarded the rate of -1% is conditional on lending benchmarks[6], the participating banks are therefore strongly encouraged to ease credit conditions and lend to compensate the repayments. However, to award the -1% rate, the ECB reviews the banks' credit performance over two periods, from March 2020 to September 2020 (to obtain the -1% rate from June 2020 to June 2021) and from October 2020 to December 2021 (to obtain the -1% rate from June 2021 to June 2022). Therefore, from January 2022, this incentive to lend will have disappeared, which may lead to a tightening of credit conditions for companies and households (**Chart 3**).

[6] *Otherwise the participating banks will "pay" the refinancing rate (0%) and the premium of -0.5%.*

Chart 3 – Credit conditions could tighten in 2022



*Source: ECB, Refinitiv Datastream, SG Economic and Sector Studies Notes: * Loans to non-financial corporations and households, except housing loans; ** data from the ECB's Bank Lending Survey.*

Launching a new TLTRO programme would allow the ECB to mitigate both risks. On the one hand, it would offer banks the possibility of smoothing out the TLTRO III repayment profile if necessary. On the other hand, it would offer itself the possibility of a more gradual exit, if necessary, from the special interest rate period.

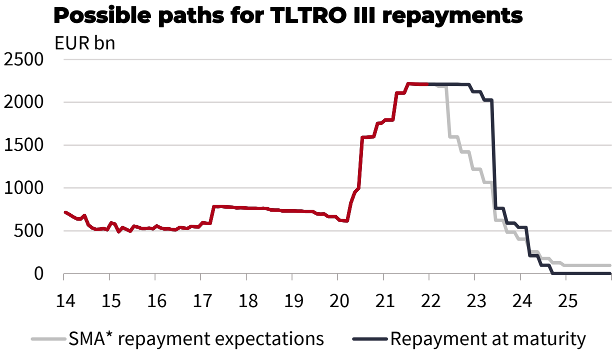
The terms of these new TLTROs would likely be less advantageous, with the ECB leaving itself the option of adjusting them in line with changing financing conditions. In particular, the premium of -0.5% would probably be removed and the lending benchmarks raised. The maturity of operations could also be shortened, borrowing requirements reduced and capped for each operation. As in 2019, TLTROs would then regain a vocation to manage the transition to a gradual normalisation of bank liquidity.

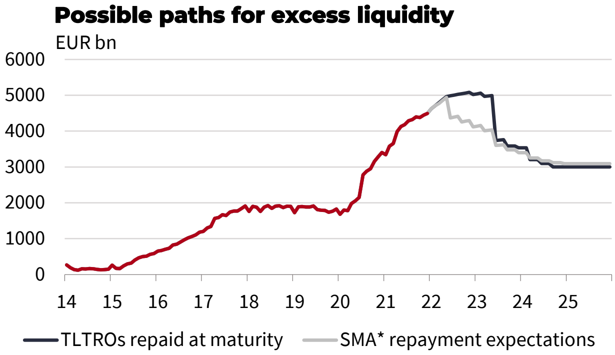
The announcement of possible new operations should take place by spring 2022 at the latest, before the residual maturity of TLTRO III.4 (June 2020) becomes less than one year. This timetable would also give the ECB time to review the dynamics of credit and financing conditions at the beginning of the year once this incentive to lend ends.

Excess liquidity will remain abundant

The full repayment of TLTRO IIIs at maturity would reduce excess liquidity by EUR 2,000bn. This would be reduced to EUR 3,000bn by 2024, i.e., EUR 1,000bn above its pre-pandemic level (**Charts 4 and 5**). This trajectory assumes that the purchases of the PEPP (Pandemic Emergency Purchase Programme) continue until March 2022 and those of the APP (Asset Purchase Programme) until December 2023, at their current pace. The Survey of Monetary Analysts (SMA), which brings together the opinion of 29 banks, sees a faster reduction path, including significant early repayments of TLTRO III in June 2022 when the special interest rate period ends.

Chart 4 and 5 – peak excess liquidity will be reached in 2022**





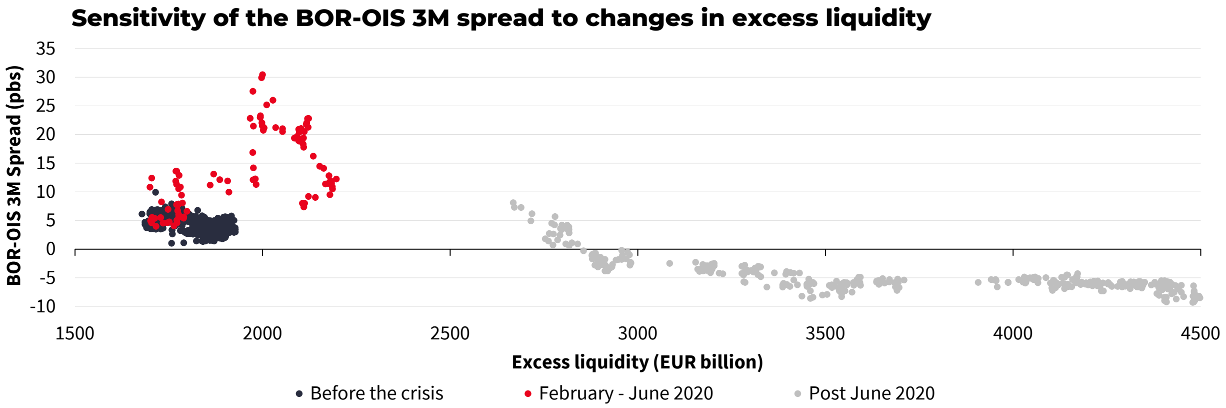
Source: ECB, Refinitiv Datastream, calculations of SG Economic and Sector Studies

** Survey of Monetary Analysts; **Assumptions: continuation of net purchases at their current pace under the PEPP (EUR 65bn per month) until March 2022 and under the APP (EUR 20bn) until December 2023. Autonomous factors and minimum reserves are frozen.*

Could this decline in excess liquidity induced by the repayment of TLTRO III cause rates to rise on the money market? With the ECB's interventions, the 3- and 6-month EURIBOR rates fell sharply. As these rates serve as a reference on the interest swap market and for bank rates charged to households and businesses, their evolution is quickly and widely transmitted to other economic agents.

The observed relationship between the evolution of excess liquidity and the 3-month BOR-OIS spread suggests that rates would start to rise as soon as the amount of excess liquidity fell below the threshold of EUR 3,500 billion, a prospect that would not occur before 2023 according to the Survey of Monetary Analysts. The launch of new TLTROs by the ECB would thus postpone the prospect of a rise in money market rates, even though the latter will also be driven by the central bank's reinvestment policy (of the assets purchased under its programmes) and the prospects for a rise in key interest rates.

Figure 6 – Euribor 3M would rise if excess liquidity declines below EUR 3,500bn



Source: ECB, Refinitiv Datastream, SG Economic and Sector Studies

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