

The ECB's Latest Gimmick

Cash for loans

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With the TLTRO II, the European Central Bank (ECB) introduced a 'cash for loans' scheme which might cost up to €24 billion, but whose impact on the real economy is likely to be marginal as banks can easily window dress their loan book.

On March 10th, the ECB made a number of important monetary policy decisions. The most important ones were an expansion of the QE programme of about €20 billion a month, with the possibility to buy (investment-grade) corporate bonds, and a new set of targeted longer-term refinancing operations for banks. We do not comment further on this expansion of bond buying because too little is known about what bonds will be bought, and under what conditions.

This contribution focuses on the new series of Targeted Longer-Term Refinancing Operations (TLTRO II), which expands the previous TLTRO in two ways. First of all, it increases the amount that can be financed from 7% to 30% of the stock of eligible loans (i.e. loans to euro-area non-financial corporations [NFCs] and households, excluding loans for house purchase).¹

¹ The small adjustment in interest rates also decided on that occasion appears of minor importance. The rate on the deposit facility was cut by an additional

The more interesting innovation is the 'cash for loans' scheme: The interest rate applied to the TLTRO II operations (with a 4 years maturity) is equal to the main refinancing operations (MRO) rate at the time of borrowing (now it is at 0%). But if the net lending of the bank is by end January 2018 2.5% above a certain benchmark the interest applied to the entire operation would go down to the deposit facility rate of (currently) minus 0.4%. In other words, the banks would be paid by the ECB if they give out more loans. The total stock of eligible loans amounts at present to over €5,500 billion. In theory 30% of this, or more than €1,500 billion, could be re-financed by this new scheme.

The TLTRO could thus become important. But is it likely to achieve its goal of encouraging the extension of credit for new investment? To answer this question we first analyse the benchmarks and the size of the incentive offered by this scheme and then show how the conditions to qualify for the cash from the ECB could be easily attained.

10bp to -0.40% and the marginal lending facility (MLF) rate by only 5 bp to 0.25%. The rate on main refinancing operations (MRO) reached 0%, after a cut of 5bp.

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Differentiated benchmarks

The most innovative element of this second TLTRO is its promise to subsidise loans if lending exceeds a benchmark. Formally there are two benchmarks: for those banks with positive eligible net lending in the 12 months before 31 January 2016, the benchmark net lending is zero. These banks need to increase lending by 2.5% (until January 2018) to get the negative rate. For those banks that had a negative eligible net lending in the 12 months before 31 January 2016, the benchmark net lending is equal to that figure. If one takes a bank with a loan book of €100 billion and a net lending, for example, of minus €4 billion over the last year, this bank would qualify for the negative rate once it reaches a negative lending of minus €1.5 billion (2.5% of €100 billion minus €4 billion).

The difference in benchmarks has a superficial plausibility. For those banks that had negative net lending, a facile assumption is that the trend would have continued to be negative. However, for banks that had positive net lending, the assumption seems to be that net lending would have been zero in the absence of this measure. A similar differentiated benchmark was adopted for the first TLTRO in 2014, when negative net lending was explicitly projected forward for one year as part of the benchmark.

This is a proposition that can be tested. We performed a simple regression analysis with banks' growth in customer loans as proxy for net lending. We separated the cases of positive and negative loan growth and then checked within each group whether there is a significant relationship between net lending in any one year, and the net lending in the following two years (because the benchmark is net lending until 2018). For the negative net lending group, we find a significant negative relationship. Hence, the banks with a net loan growth below zero in any one year are likely to have a positive loan growth in the consecutive two years. The result is significant at the 1% level. However, for the cases of positive net lending we do not find any significant relationship with future lending.

This simple result implies that the different benchmark for banks with negative net lending

in 2015 might not be appropriate: banks that had negative net lending in any one year are anyway likely to bounce back with positive net lending in the following 2-year period. This regularity from the past indicates that especially the banks with negative net lending are likely to receive the ECB premium, even if they do not change their lending policies.

It is also likely that this benchmark scheme may lead, de facto, to nationally differentiated monetary policy stances (or rather fiscal incentive schemes). In effect, the interest offered to banks is a function of past lending volumes and the lending pattern within each country tend to be highly correlated. Banks in countries where lending volumes had recently been contracting sharply would qualify for the -0.40% interest rate subsidy if they merely reduce the rate at which lending falls by 2.5% points.

The cash incentive

The incentive for additional lending could be substantial, if viewed against the entire lifetime of the operation. For instance, a bank for which the benchmark is zero and which had €100 billion in eligible lending outstanding, as of January 2016, could borrow up to €30 billion under the TLTRO II at zero interest. If this bank then extended an additional €2.5 billion of credit to NFCs or households by January 2018, it would qualify for the lower interest rate on the entire amount it has outstanding under the TLTRO II (up to a maximum of €30 billion). Instead of 'paying' zero interest, it would get annually from the ECB 0.40% on (up to) €30 billion in cash, or a maximum of €0.12 billion. As this will be valid for the entire lifetime of the operation (4 years), the total subsidy would be (at most) €0.48 billion. Compared to the additional risk to its balance sheet of €2.5 billion, which the bank incurred in order to qualify for the interest rebate, this amounts to almost 20% ($0.48/2.5$).²

² Moreover, the financing conditions of the TLTRO II contain an option element as the rate is fixed, but repayment is at the discretion of the borrowing bank. There is no longer mandatory early repayment, even if net lending falls below the benchmark. Non-

The incentive provided by the ECB can be compared with the Juncker plan, which also provides a subsidy to investment, but on a project basis with a risk reduction of around 6.7%: every euro of EU capital put at risk was supposed to generate €15 of investment (= 6.7% first loss or equity). There now exists a substantial list of investments to be financed, but it is not clear to what extent this represents simply pre-existing projects that have been re-jigged so that they qualify for this subsidy.

A cost of additional loans, of course, is that they require additional capital. However, this cost is always there and covered by the interest rate spread charged to borrowers, under normal circumstances. Window-dressing loans would also require more capital. This additional cost should be moderate: assuming a 50% risk weight and a capital ratio of 12%, banks would have to hold €60 million extra capital for each billion of extra net lending. Assuming a cost of capital of 10% per annum, the total capital cost would be €24 million over four years.³ In the example above, the total capital cost of 'window dressing loans' of €2.5 billion would be €40 million, a fraction of the interest rate subsidy of up to €480 million. Moreover, one has to keep in mind that actual aggregate net lending would need to grow much less than 2.5% even if all banks qualify for the interest rate reduction since for many banks the benchmark is a fall in lending. Given that this is the case for about one-third of all banks, it follows that aggregate lending growth would not have to be much larger than the one observed until today (close to 1%) to allow most banks to benefit from the cash hand-out under the TLTRO II.

But the fate of the first TLTRO already showed that money is fungible par excellence. Banks can easily window dress their loan book, for example, by handing out loans for 'working capital' under which the bank gives a loan at

performing loans also count under the total eligible for the calculation.

³ This is actually a maximum cost, since the net lending benchmark is based on the stock as of January 2018, if some of the loans outstanding at this point in time are repaid earlier the additional capital would not be needed for four years.

zero interest to a company, which is then required to put the proceeds into a blocked account (possibly also at zero interest) as collateral. Moreover, banks can form groups (as allowed under TLTRO I). Within any group, those banks just under the benchmark (+2.5%) could benefit from the net lending of others, which are much above the benchmark and thus qualify anyway for the interest rate subsidy. The real new credit may (again) only be a fraction of the total TLTRO borrowing.

Macroeconomic impact

Total outstanding loans eligible under the TLTRO II are around €5,500 billion, implying that theoretically the total amount requested by banks could be up to €1,650 billion. From this sum one has to deduct the outstanding TLTRO (I) volume, leaving about €1,500 billion for the TLTRO II.

The total expense (or loss of seigniorage revenues for the ECB) would be, under this hypothesis, about 0.40% of €1,500 billion, or €6 billion for four years or €24 billion. This is a considerable sum for the euro area banking system; and this perspective explains why banking shares jumped after the announcement. However, given that there is not necessarily a link between loans and investment, the 'cash for loans' scheme might have a very limited impact on the real economy.

Given the subsidy rate of about 20% calculated above the total amount of 'incentivised' loans (i.e. the lending which might not have materialised otherwise) would be about €120 billion. The hope of the ECB might have been that these new loans would correspond to additional investment or consumption which otherwise would not have been undertaken. If this had been the case, the boost to demand would have been considerable, worth a bit more than 1% of euro area GDP. However, as shown above, it is unlikely that banks would actually finance new, risky projects when they can qualify for the cash without taking any risk.

This potential €24 billion of explicit interest rate subsidy would be larger than the €21 billion total EU funds committed to the Juncker plan. If one puts these two measures together, one

obtains a total of about €45 billion of public money committed to increasing investment. It remains to be seen whether all this funding will lead to a substantial amount of new investment.

Monetary versus fiscal policy

Finally there is the question whether subsidising loans over a specific period of investment represents monetary or fiscal policy. The ‘cash for loans’ element in the TLTRO II is different from a ‘normal’ reduction in the lending rate which would apply to all new lending. All monetary policy decisions have some fiscal implications because any lowering of the lending rate leads to a loss of revenue for the ECB (or, more precisely, the Eurosystem) – unless the deposit rate is also lowered at the same time. Lowering the lending rate can thus have a direct impact on the so-called monetary income (in jargon, seigniorage) of the Eurosystem that is then distributed via the national central banks to national treasuries.⁴ In 2014, the TLTRO I did not involve any loss of revenue since the rate was set at the normal refinancing rate plus 10 basis points. The Governing Council could have lowered the lending (MRO) rate on March 10 of this year to minus 40 basis points. This would also have led to a large loss of revenue unless the deposit rate had also been lower to keep a difference between the two. Changing one or more of its policy rates would clearly be in the realm of monetary policy. But trying to influence lending decisions with a temporary subsidy is something that normally governments do (typically in the form of state guarantees to lower the funding cost).

There is a close precedent for the TLTRO II in the form of the Funding for Lending (FLS) scheme adopted in the UK in 2012 (see the box below for details), which elucidates the border area between monetary and fiscal policy.

⁴ There are of course other, indirect fiscal implications through the link between ECB policy rates and the market for short-term government paper. But these indirect effects are not the key issue for the TLTRO II.

The UK experience with the Funding for Lending Scheme (FLS)

In principle, the UK scheme had a similar objective as the TLTRO II: to motivate new lending. But, when it was launched in 2012, funding costs of banks were elevated (up to 200 basis points above official rates), possibly because of the euro crisis, which cast a shadow over all European banks. Elevated funding costs are no longer an issue today. Moreover, the FLS was limited to 5% of the loan book, and it did not give banks direct access to funding, but only allowed them to ‘borrow’ government bonds as collateral. There was to be a fee attached to the lending of the collateral. This fee was to be lower for banks with increasing loan books. The Bank of England (BoE) estimated that the total cost of converting the borrowed gilts into cash was about 75 basis points, which is higher than the direct discount window.

The FLS thus did not involve any expenditure by the Bank of England, only some ‘rebate’ on the normal fee that the bank charged to banks, which would not increase their loan book.

It is interesting to note that the committee which normally sets the policy instruments at the Bank of England, namely the Monetary Policy Committee (MPC), apparently did not even vote on the scheme. It only made the following cryptic comment:

The Monetary Policy Committee (MPC) has judged that there will be no material impact on the stance of monetary policy.

This can only be taken to mean that the MPC did not even consider the FLS to be a monetary policy instrument.

The effectiveness of the FLS is difficult to determine even some years later. Gros, Alcidi and Giovannini (2014) express scepticism about the basis of the lending data. Lending growth actually fell in the first year after its implementation. However, the FLS was renewed and lending rose for a while after two years, only to fall back again later.

A study by the Bank of England (Churm et al., 2015) comes to a much more positive conclusion based on the fact that overall funding costs for banks fell considerably after the introduction of this measure. But even this study did not firmly establish that the FLS contributed more than other macroeconomic factors to the drop in funding costs; and then that this drop resulted in greater investments in the economy. Churm et al. admit, however, that the samples they assess are still small and may not necessarily have captured all channels that affect funding costs or have an impact on growth and inflation. There are also other factors, beyond funding costs that can affect the investment channel.

From the outset, the Bank of England was aware that its scheme was situated on the borderline between monetary and fiscal policy, leading to the release of the following official statement:

The Bank has therefore sought and received an assurance from the Government that the objectives of the Scheme lie within its remit (as noted in the exchange of letters between the Governor and Chancellor on 13 July). And the Funding for Lending Scheme itself will be overseen by a joint Bank/HM Treasury Oversight Board, which will meet on a quarterly basis.

In the UK, the conclusion was apparently that the Funding for Lending scheme was still in the grey zone between monetary and fiscal policy. A practical solution to represent the fiscal authorities was found in the form of a joint oversight board. Such a practical solution would de facto be very hard to implement in the euro area, as it would require a representation of the ECB and national finance ministries on a joint Board (or perhaps on the Eurogroup Presidency) to oversee an ECB monetary policy instrument.

But in reality the fiscal authorities should have been involved since the TLTRO II represents clearly a commitment of public (euro area) money – even more so than the FLS.

The ECB is clearly testing the limits of its mandate by stepping into the fiscal policy space. Is this what a central bank should be doing? Even if the economic benefit is likely to be slim? The jury is still out.

References

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