Who needs another LTRO?

- **The ECB is signalling that there will be a further LTRO**
- **But they will also penalise banks making use of this facility**
- **LTROs help liquidity; they do not boost money or credit growth or repair balance sheets**

Now that US politicians have gotten their act together – for the time being, at least – it is time to turn to the other high-risk issue for the world economy, namely the euro area and its banks. The EA banking union continues to stumble towards completion. Last week the ECB announced the outlines of its imminent Asset Quality Review. The most notable components were that larger institutions will need a higher capital ratio (8%, rather than 7%) and that different capital definitions will be used for the AQR and for the eventual stress tests. Of further interest, ECB President Mario Draghi has made it almost 100% clear that at least some banks will fail the stress tests in order to enhance their credibility.

Meanwhile, the Bank is clearly considering another long-term refinancing operation (LTRO).[1] This begs the question 'why?' As noted in a previous Comment (*Further to EA MFI balance sheets*, 15th August, 2013), euro area banks have actually repaid large chunks of the two previous three-year LTROs from December 2011 and March 2012. As of September 2013, the stock of LTRO loans for the entire Eurosystem (the ECB and national central banks) stood at €670bn, down 48% from a peak of €1,079bn in June 2012 (please note that this covers the two three-year LTROs as well as other, shorter, LTROs).

However, as is so often the case with the EA, the whole masks the parts. In this case, while banks in some countries, notably Germany and France, have repaid much or most of the loans they took out, banks in some other countries, notably Italy, have held on to their cash. While there is as yet no urgency – funds from the first three-year LTRO only need to be repaid in December 2014 – the ECB is concerned enough about liquidity problems to consider ways of injecting more liquidity when needed.

Data from the national central banks unsurprisingly show that Italian, Spanish and Portuguese banks were among the biggest borrowers in the two three-year LTROs. Portuguese banks' LTRO borrowings peaked at €533bn in 2012; those of Spanish banks at €338bn and those of Italian banks at €273bn. By contrast, German and French banks' LTRO borrowing peaked at €77bn and €174bn respectively. Relative to their November 2011 balance sheets, German banks borrowed an extra 0.7%; Portuguese banks borrowed 33.7%.

[1] Strictly speaking, an LTRO is a refinancing operation with a duration in excess of three months. Recently, it has generally come to describe one- or three-year repos. In this Comment, unless otherwise noted, references to past LTROs are to the December 2011 and March 2012 three-year operations. It is not clear whether ECB plans refer to a one-year or a three-year LTRO – or indeed to any other period, eg, two years.

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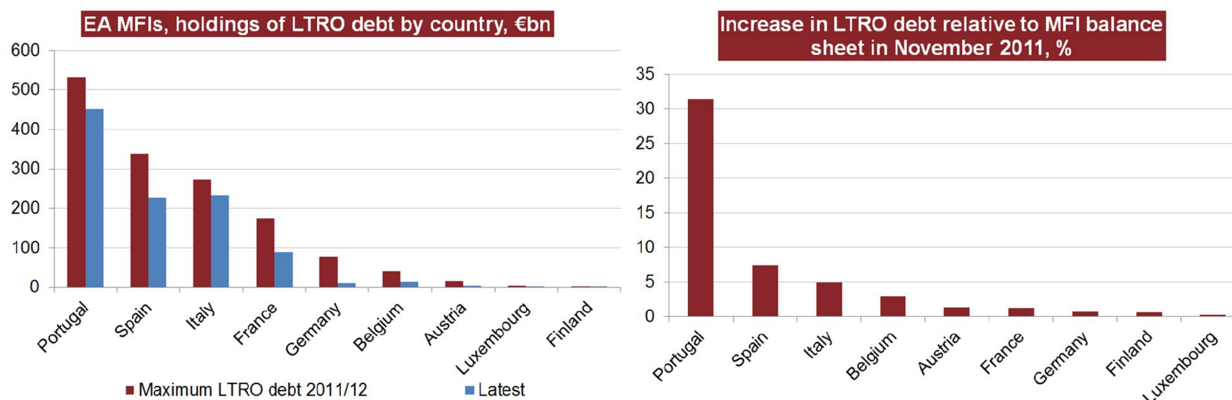

But perhaps the biggest difference is in the scale of the repayments. According to the latest available data (varying between August and September 2013), German banks had repaid 86% of their total borrowing and French banks 48.9% of theirs. By contrast, Italian banks had repaid 14% of their borrowing and Portuguese banks 15.3% of theirs. Spanish banks were somewhere in the middle, having repaid 33% of their total borrowing.

Clearly, Italy and Portugal are the countries where banks still face a substantial liquidity problem. Arranging another LTRO is an easy way for the ECB to inject further liquidity where needed. But, where previously the LTROs were a good way of providing extra liquidity without necessarily stigmatising banks who took up the offer, this is no longer the case. The ECB has made it clear that banks making use of the facility will now also be penalised by having the European Banking Authority mark down any bank that uses an LTRO by comparing the subsidised scheme's low financing costs with the real market funding rates the bank would otherwise have to pay.

This is because while it is all well and good to provide extra liquidity to help banks with funding gaps, there are three things that an LTRO will not necessarily do. The first is that it will not halt the continuing shrinking of EA banks' balance sheets – some of it due to the need to make further provisions for bad loans, but much also due to regulatory insistence on increasing capital buffers. All an LTRO does is to replace one type of item on a bank's balance sheet with one that is likely to be more secure and cheaper; but balance sheets do not expand. Second, and connected with the first point, it will neither spur broad money, nor credit growth. Third, it will not at all improve the underlying quality of banks' balance sheets.

This is all relevant for the ECB as it limbers up towards the AQR. There have been various rumours about how big a shortfall in EA banks' capital this is likely to show, ranging from a manageable €50bn to a probably unmanageable €750bn. But the AQR is suffering from living in the shadow of the widely derided "stress tests" performed in 2011 which gave clean bills of health to almost all EA banks, including Dexia, which failed shortly afterwards. As shown by recent comments from President Draghi, the ECB knows that it cannot afford a repetition of the whitewash; but neither can it accept a result that will cause market panic.

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Injecting further liquidity will at least buy more time. This is clearly one of the ECB's aims, in line with President Draghi's statement at his press conference following the latest meeting of the Governing Council that "Nobody wants to have a liquidity accident standing between now and a recovery." But the more important aim is likely to be to accelerate the process of forcing EA banks to face up to their solvency issues, ie, their lack of capital by making it clear that the massive 'free' liquidity injections will not continue forever. Almost certainly with the euro area taxpayer providing at least a goodly chunk of the missing funds.

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