

Global financial markets

ECB LTRO: probably not enough

- The ECB has issued a three-year long-term refinancing operation (LTRO) amounting to EUR 489bn. The net new amount is lower: EUR 235bn.
- Given the relative size of the new net funding for refinancing needs, we keep our cautious stance on the economic and financial market outlook.

Today, the European Central Bank (ECB) announced the allotment of three-year financing to 523 banks amounting to EUR 489bn through its Long Term Refinancing Operation (LTRO). The LTRO was made public at the last ECB press conference on 8 December. The net increase after accounting for expiring ECB funding operations is less, however: EUR 235bn. To put this number into perspective, EUR 230bn of bank bonds mature in 1Q 2012 according to Mario Draghi. The three-year LTROs this week and in February raise the question of the economic and financial market implications. For this purpose we will first assess the background of this measure.

According to ECB President Draghi, the three-year LTROs should help banks refinance at medium-term maturities and support lending, especially to small- and medium-sized enterprises. To that end, the ECB lowered collateral requirements, i.e., rating requirements have been reduced and part of the EUR 7 trillion bank loans sitting on banks' balance sheets will be eligible as collateral for ECB funding. The LTRO will allow banks to secure funding for three years at the average rate over the tenor (currently the rate is an ultra-low 1%), while access to private funding is highly limited. It will also help to address the asset liability mismatches on their balance sheets. This should boost confidence in the system.

What will be done with the money raised? While the banks (at least officially) decide on their own, the LTRO can be used either to finance additional business (i.e., expansion of the balance sheet) or refinance maturing bank liabilities (i.e., balance sheet neutral). We differentiate four key options:

- increase lending (balance sheet expansion)
- improve liquidity position (balance sheet expansion)
- buy government bonds (balance sheet expansion) or
- refinance bank liabilities (balance sheet neutral)

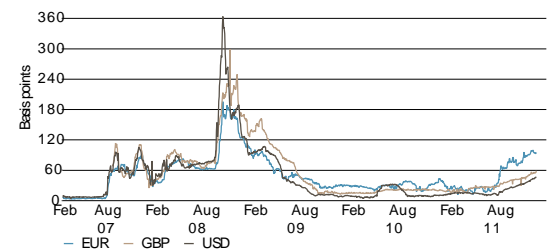
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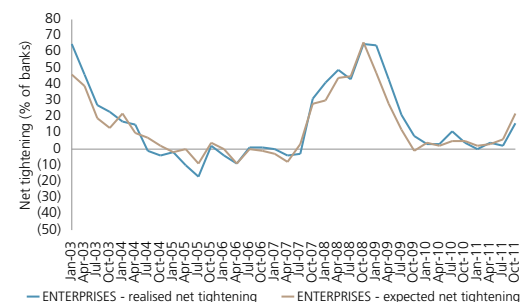
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Fig. 1: Stress in the interbank market
Market funding is very expensive



Source: Reuters Ecowin, UBS WMR

Fig. 2: Bank lending under pressure
ECB lending survey



Source: ECB, Bloomberg

On the first option, banks are overall unlikely to widen significantly the amount of lending in the middle of a major deleveraging exercise and a retreating economy. In terms of the second option, banks that are starved of liquidity would take advantage given the dry interbank market.

We believe that some banks will use part of the new funding for this purpose, which might flow back to the ECB through the deposit facility.

The third option is much debated. At the first glance, the carry trade between the 1% LTRO rate and government bond yields is very large. Unfortunately, banks would have to take these bonds on an unhedged basis, because CDS premiums are very high. In addition, it would require additional capital during the current deleveraging process and bears the risk of new bank stress tests during the three-year tenor of the LTRO. We would therefore expect limited uptake for carry trade purposes, even though media reports suggest that large banks might be pressured to buy government bonds. In fact, comparing the net new funding (EUR 235bn) with the refinancing needs, it seems that little will be left for carry trades. More interesting, though, is that the ECB President publicly implied on Monday in the Financial Times newspaper that ECB-financed government bond purchases by credit institutions is not in violation of the EU Treaty. The question of a breach might need reconsideration if, for example, the European Financial Stability Facility (EFSF) and/or the European Stability Mechanism (ESM) were granted a banking license in the future and would buy government bonds with ECB financing.

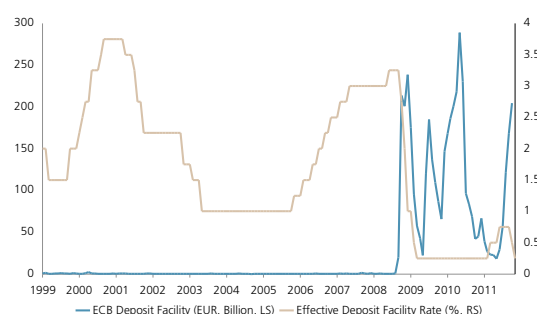
The fourth option refers to one of the main objectives of the ECB, to have the banks fulfill their financial needs at low costs during heightened market stress. This, of course only applies to financing beyond what was already at the ECB, i.e., EUR 235bn rather than the headline figure of EUR 489bn. This net increase of financing at the ECB would help banks in the deleveraging process, as it helps to counterbalance the negative effect from increasing non-performing loans (NPL). In addition, it gives banks more certainty over medium-term financing. We believe banks will use the new funds mainly for refinancing purposes.

In summary, we would expect the net increase of financing through the three-year LTROs mainly to be used for refinancing banks' liabilities at very low cost and to improve their liquidity positions, with limited extra lending or government bond purchases. Additional demand should come through at the February LTRO, as banks may well have overcome technical difficulties of using credit claims as collateral and had more time to decide what to do with this new financing possibility. Also, the reduction in the ECB reserve requirements from 2% to 1% for banks has freed up over EUR 100bn, which has partly reduced the immediate needs until the February LTRO tender.

Our GDP forecast for the Eurozone is already factoring in monetary support by the ECB, hence we uphold our forecast of -0.7% for 2012 as long as fiscal tightening and bank deleveraging is implemented as planned and uncertainty remains high. What this measure does change, though, is the probability of negative tail risks. On the inflation side, the money drawn today from the LTRO in excess of what was already provided before by the ECB is not sterilized. Nevertheless, the impact on inflation should be limited, since given the market stress, the money allotted is filling a void in the interbank and bank bond markets.

Fig 3: ECB deposit facility

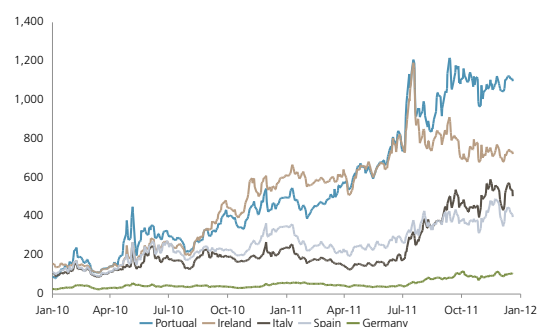
Banks currently depositing liquidity back at the ECB



Source: ECB, Bloomberg

Fig. 4: Sovereign CDS premiums

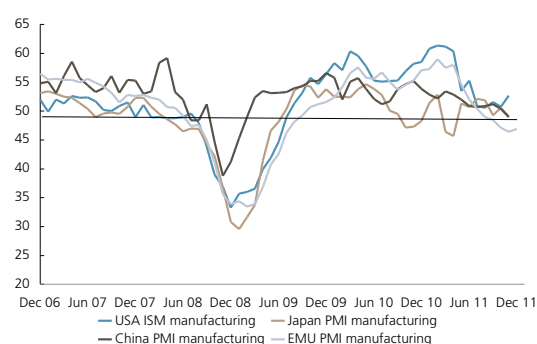
Hoping for the carry trade?



Source: Bloomberg

Fig 5. Manufacturing PMIs

Signaling a Eurozone recession



Source: Bloomberg

Muted short-term impact on equities

The funding provided by the ECB helps banks to refinance their maturing debt in the first quarter of 2012. Thus, the ECB liquidity should help to ease some stress banks would otherwise face. Another auction will be held in February – probably to cover the liquidity needs thereafter. All in all, the ECB loans can be seen as mildly positive, since liquidity needs for the next three months seem to be satisfied. Still, the risk of a default by Greece is not removed. Therefore, we do not change our stance and remain cautiously positioned on European banks for the first quarter of 2012.

Impact on credit

Allowing loans to banks as ECB collateral, in our view, is quite similar to providing the banking system as a whole with unsecured funding. In addition, the ECB allows every bank to borrow as much as it requests against available collateral. Providing medium-term funding is important to prevent substantial asset-liability mismatches for banks that are unable to tap bond markets for term-funding.

However, from a bondholder perspective, using more of a bank's high-quality assets to collateralize ECB borrowing lowers the average quality of assets effectively backing unsecured bonds. Therefore, the ECB measures may help to ease short-term funding pressure, but this comes at the cost of possible further senior bond-rating downgrades and an even more impaired access to unsecured funding.

In our view, the risk of weaker banks being nationalized and bondholders being forced to contribute to a restructuring is not limited to peripheral European markets. We maintain a conservative positioning within the financial sector and recommend a reduced allocation to bank bonds. Subordinated bonds of Eurozone banks should currently be avoided entirely.

Overall, we maintain our preference for non-financial corporates over financials.

Impact on fixed income

The intraday reaction to the first three-year LTRO has been twofold. The initial reaction has been positive, with German yields increasing and an observed narrowing of spreads in the Eurozone as the announced volume was bigger than expected. But after the initially positive reaction, sobriety set in as the headline figure turned out to be much bigger than the effective size of the tender, taking into account the short-term contracts that were not rolled over but rather shifted into the three-year LTRO. This explains the erratic intraday movements: first 10-year Bund yields rose to 2% and then declined 10 basis points, and in contrast, yields in the periphery first declined and then reversed the initial narrowing again.

Overall risk aversion had declined already before the announcement of the tender, as expressed by diverse volatility indices and less flight into the safer sovereigns such as US Treasuries or German Bunds. As a result, the prices of 10-year US Treasuries and German Bunds fell, and their respective yields rose since 19 December by roughly 10 basis points. First the stress in the interbank market has eased slightly as expressed by a slight declining spread between the 3-Month Euribor and EONIA (Euro Overnight Index Average). Second, government bond spreads in the Eurozone compared to the German Bund yield declined over the week.

Going forward, we believe the announced tender will be able to ease the pressure on the interbank market over the next two months, and help spreads in the Eurozone to narrow or at the very least to stabilize.

Taking all these arguments together, we believe that over the short term the announced tender will ease pressure on the interbank market and likely reduce the sovereign spreads, but over the longer term the movement in yields depends on whether the new cash facility helps to ease the path towards a structural improvement in Europe.

ECB's cash operation limits downside and upside risks for the euro

What does it all mean for the euro? We think the operation limits the upside and the downside risks for the euro.

Upside risks for the euro emerge currently from a potential liquidity squeeze in the European banking system. That means, once banks and other financial companies have difficulty accessing cash on the open market, their demand for euros drives the currency up. The LTRO operation of the ECB sets clear limits to such a negative outcome. Downside risks for the euro emerge from recession fear, a Greek default and worries about the stability of government financing. The success of LTRO is not great enough to ban these fears completely. The operation does not imply a long-term solution for Europe. Nevertheless, it limits these downside risks and therefore helps to stabilize Europe and the euro.

Authored by Tom Flury

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1Q, 2Q, etc. or 1Q11, 2Q11, etc.	First quarter, second quarter, etc. or first quarter 2011, second quarter 2011, etc.	A	actual i.e. 2010A
E	expected i.e. 2011E	GDP	Gross domestic product
NV	Neutral View: The stock is expected to neither outperform nor underperform the relevant benchmark nor significantly appreciate or depreciate in absolute terms.	NPL	Non-performing loans
p.a.	Per annum (per year)	Shares o/s	Shares outstanding
UP	Underperform: The stock is expected to underperform the sector benchmark	WMR	UBS Wealth Management Research

Appendix

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