Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

How Big was the LTRO, Really?

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Lorcan Roche Kelly

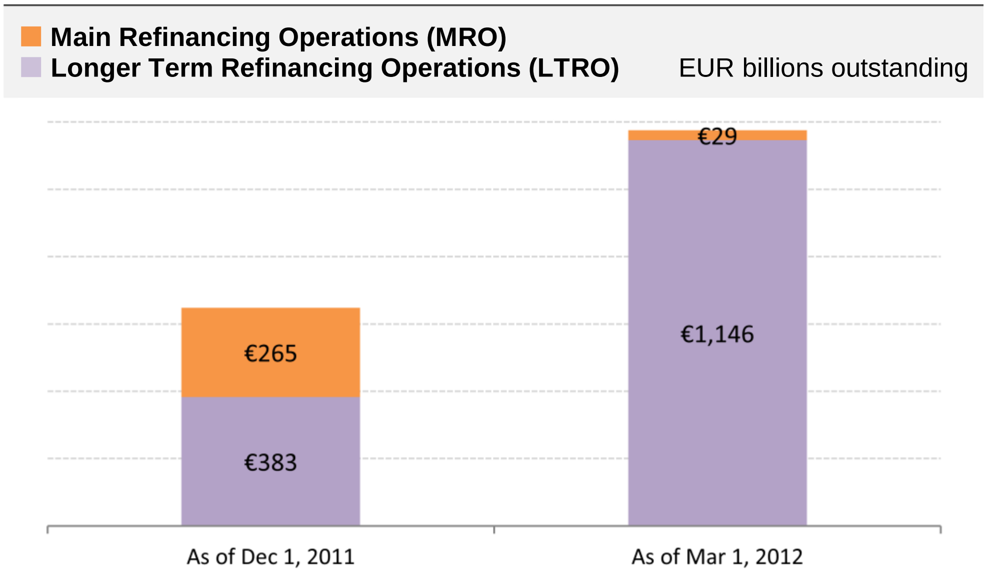
Size matters -- but for central bank liquidity, quality means as much as quantity.

With the second 3-year Longer-Term Refinancing Operation (LTRO) now in place (see "On the Second 3-year LTRO" February 29, 2012), let's take a deeper look at the numbers, as a starting point for a view on what will likely be its long-term effects.

- The most important concept to grasp here is that while it is natural to focus on the *quantity* of liquidity provided in the two LTRO's -- this is, after all, a version of *quantitative* easing -- in fact what is more important is the *quality* of the liquidity.

To grasp the quantity *and* the quality of liquidity provided, we will compare two time periods: first, December 1, before the ECB had announced the two 3-year operations; and second, March 1, the first day after the completion of the second 3-year operation.

First up, here are the numbers by operation type (please see the chart below):



Source: ECB, TrendMacro calculations

Update to strategic view

ECB, EUROPE FINANCIAL STOCKS: Analysis of the ECB's 3-year LTROs has to take into account the average time that liquidity has been provided for, giving a measure of the quality of the liquidity, not just its quantity. Quantitatively, though the two operations were large, net liquidity has less than doubled. But qualitatively, the average time to maturity of each euro of liquidly has increased by a factor of 20. The positive effects of this on euro area banks should not be underestimated.

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The two 3-year LTROs, taken together, have increased the quantity of liquidity by €527 billion overall. But the key to understanding the *quality* is to observe in the chart the transformation of Main Refinancing Operations (MRO) liquidity into LTRO liquidity.

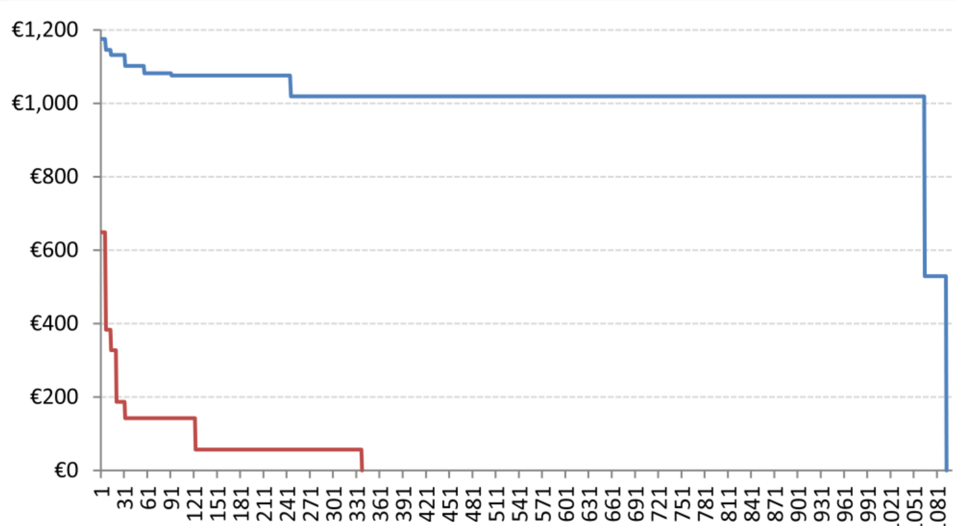
- MRO is short-term -- it is the standard 7-day liquidity-providing operation of the ECB. After seven days it rolls off, and can only be replaced if the ECB is willing. So like any financing, it presents some degree of rollover risk for the borrower. On December 1 it was €265 billion. On March 1 it was €29 billion -- the lowest it has been in the history of the ECB.
- LTRO is long-term. On December 1 it was €383 billion, with most of the funding from 3-month and 6-month operations. On March 1 it was €1146 billion -- the largest it has ever been in the history of the ECB -- with most of that record funding provided on 3-year terms. Now borrowers have financing locked in for three years, and so rollover risk is deferred into the distant future.

This means the average maturity of the liquidity provided by the ECB has markedly increased -- in fact, it has done so to a staggering extent. In the chart below we show the time-path of the quantity of locked-in liquidity, by days to maturity, comparing December 1 and March 1. Each "stair-step" down in the chart is a rollover risk event for the borrowing banks. What jumps off the page is the extent to which rollover risk has been pushed into the future -- thus assuring banks of financing, and taking a Lehman-type liquidity crunch off the table.

- On December 1 only 22% -- €142 billion -- of liquidity extends beyond one month. Today, 93% -- €1101 billion -- of liquidity extends beyond one month, with the ECB committed to €1018

ECB liquidity, by days to maturity EUR billions outstanding

As of December 1, 2011 **As of March 1, 2012**



Source: ECB, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

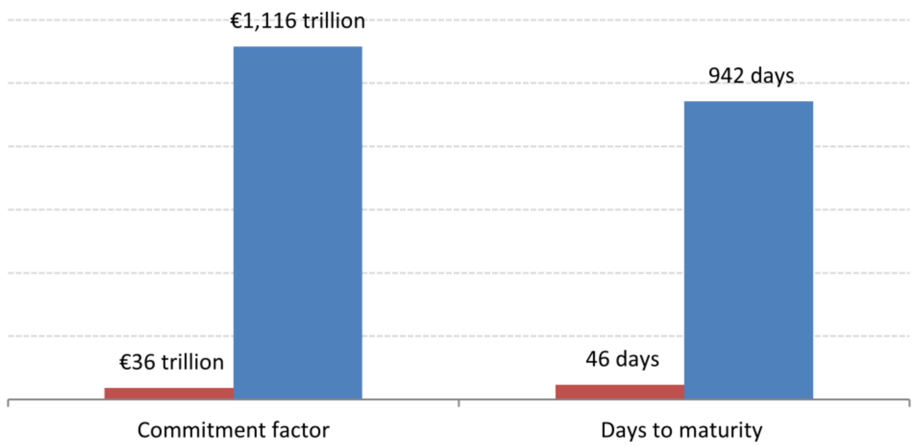
John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

billion to January 2015.

- The average maturity of a euro of liquidity provided by the ECB on December 1 was 46 days. Today it is 942 days, an increase of 20 times (please see the chart below).

Qualitative measures of ECB liquidity outstanding
— As of December 1, 2011 — As of March 1, 2012

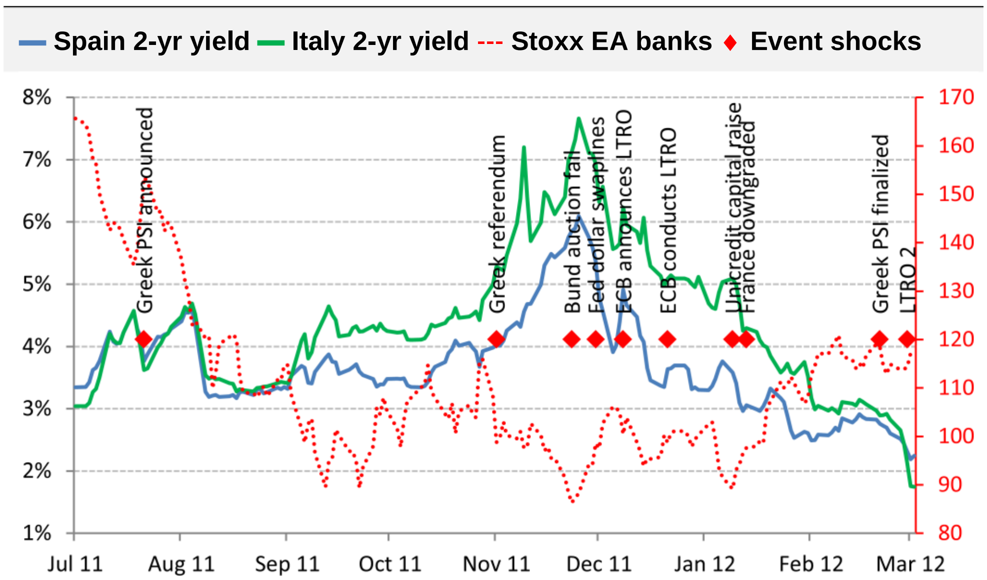


Source: ECB, TrendMacro calculations

- Because the most important property of this maturity extension is asymmetric lock-in -- the ECB commits itself to the banks for three years, yet the banks can opt out after one year -- we have calculated what we call the "commitment factor." This is the summation of the number of euros committed each day until maturity (it is equal to the areas under the curves in the chart on the previous page). Today, the "commitment factor" is 31 times what it was on December 1 (again, please see the chart above).
- To be sure, the ECB was going to continue with liquidity operations after December 1 -- that is, 46 days was never a countdown to an absolute end of liquidity. And the cost of ruling out rollover risk for three years does have a dark side. It may be viewed as a "cliff" as the ECB rapidly withdraws nearly a trillion euro of liquidity over a 1-month period in 2015. But there are two factors that mean this risk is not as severe as one might fear.
- Euro area banks have the option to withdraw from the 3-year operations any time after the first year of the term has passed. If the liquidity situation in the euro area improve over the coming months and years, it is likely that the banks will reduce their reliance on these operations, reducing the size of the cliff.
- The ECB has, throughout the crisis, done what has been needed for the banking sector. It will not, if the situation were to arise, allow banks to suffer a liquidity crisis through the ending of the 3-year LTROs. Throughout the term of the 3-year LTROs there will be other term liquidity operations running, such as 6- month, 3-month and 1-month operations. The ECB will make sure to smooth the transition from the 3-year operation in 2015.

For the stronger banks in the euro area, the 3-year LTROs are an attractive formula: *liquidity plus time equals increased profitability*. For the weaker banks, the 3-year LTROs may make liquidity plus time equal solvency and survival. Either way, by improving the *quality* of the liquidity it has offered so hugely the ECB- has given the euro area banking sector a new range of opportunities.

- We mentioned improving the liquidity coverage ratio (LCR) (again, see "On the Second 3-year LTRO") as possible use of funds for euro area banks. Under the LCR as proposed by Basel III, banks must have enough liquidity to cover cash needs under a stress scenario over a 30-day period.
- By giving banks access to 36-month liquidity, banks have been able for regulatory purposes to turn less liquid assets into close-to-cash and improve their LCR for the next 35 months (as the new liquidity will not count for the last month as it will be within the 30-day window).
- Banks must have also been engaging already in the sovereign carry trade (please see chart below), with yields on Spanish and Italian debt falling to levels not seen since before last August's blow-out.



Source: Bloomberg, TrendMacro calculations

- Regarding bank lending, the worst case scenario for the euro area is now that banks will not increase lending. This is a major turnaround from three months ago when banks were actively looking to reduce lending due to liquidity concerns. Now, LTRO liquidity means that banks are able to maintain their lending at current levels -- at a minimum -- as they know they will not get caught in a liquidity trap, or on the wrong side of Basel III.
- Increase in loan growth needs both available funds and borrowers who are both willing and creditworthy. The banks have the available funds, which squares at least half of the circle. The availability of borrowers is more of an unknown.

Bottom line

Analysis of the ECB's 3-year LTROs has to take into account the average time that liquidity has been provided for, giving a measure of the quality of the liquidity, not just its quantity. Quantitatively, though the two operations were large, net liquidity has less than doubled. But qualitatively, the average time to maturity of each euro of liquidly has increased by a factor of 20. The positive effects of this on euro area banks should not be underestimated.