



EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB-PUBLIC

COURTESY TRANSLATION

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President

Mr Marco Valli and Mr Marco Zanni
Members of the European Parliament
European Parliament
60, rue Wiertz
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L/MD/16/11

Re: Your letter (QZ-161)

Honourable Members of the European Parliament, dear Mr Valli, dear Mr Zanni,

Thank you for your letter, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 11 November 2015.

When assessing the effectiveness of a monetary policy measure, or any policy measure for that matter, it is necessary to consider how the economic variable would have evolved in the absence of this measure. In the specific case of the targeted longer-term refinancing operations (TLTROs), this variable is the expansion of bank loans to firms and households. The TLTROs were in fact designed to enhance the functioning of the monetary policy transmission mechanism by supporting bank lending to the real economy.

Allow me to elaborate on the way that TLTROs are designed and their effect on the lending activity of those banks participating in these operations. It should always be recalled that a range of factors affect the evolution of loans. These include demand-side factors, such as the availability of profitable investment opportunities in the economy and the size of legacy debt burdens in the private sector; and supply-side factors, such as the capitalisation of the banking system and the level of non-performing loans on bank balance sheets.

When the TLTROs were launched, some banks in the euro area – and entire banking systems in certain vulnerable countries – were facing the need to deleverage, which in some cases resulted in restructuring plans. This meant that for certain banks a net expansion of their lending portfolios was not possible, at least

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for some time ahead. This aspect was taken into account in the design of the TLTROs, which allows banks to access the operations while proceeding with the necessary deleveraging, as long as the pace at which they are shrinking their loan portfolios is reduced. Such a reweighting of their deleveraging away from loans in fact constitutes an increased supply of loans compared to what would have been the case had the TLTROs never existed. At the same time, the design of the TLTROs also requires banks eventually to stop deleveraging and actually increase their eligible loans (loans to firms and households excluding loans to households for house purchase) in order to continue benefiting from accessing the operations. Indeed, from April 2015 the benchmark that banks need to exceed in order to be eligible for borrowing from the TLTROs and which defines their borrowing allowances requires strictly positive eligible net lending. Going forward, therefore, this is expected to translate into higher positive lending flows to firms and households.

Thus far, it is indeed the case that banks that have borrowed from the TLTROs have also tended to repay other liabilities, such as bonds but also existing borrowing from the Eurosystem. This funding substitution is in fact the main channel through which the TLTROs are improving the availability and pricing of bank loans for firms and households. It operates in two ways: first, it reduces the cost of funding for banks, which can then pass on the reduction to the end borrower; and second, it extends the maturity of bank funding so that it can better match that of loans.

The funding substitution made possible through the TLTROs is having tangible effects on the pricing of loans to firms and households. Until the announcement of the TLTROs in June 2014, the reductions in the European Central Bank (ECB) monetary policy rates were incompletely and unevenly reflected in the decline of the cost of borrowing from banks for non-financial corporations (NFCs). While the rate on the ECB's main refinancing operations had been reduced by 1.25 percentage points between October 2011 and May 2014, the decline in the cost of borrowing from banks for NFCs in vulnerable euro area countries over this period was only about 0.4 percentage points. Since June 2014, however, the TLTROs, together with the other standard and non-standard monetary policy measures deployed by the ECB, have resulted in a reduction in the cost of borrowing from banks for NFCs in vulnerable euro area countries of about 1.2 percentage points. Moreover, there is evidence (at individual bank level) that links access to TLTROs to more aggressive reductions in lending rates during this period.

Overall, therefore, there is ample evidence that the TLTROs, together with the other measures recently introduced by the ECB, have contributed to a significant relaxation in the financing conditions faced by firms and households in the euro area.

Yours sincerely,

[signed]

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