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GLOBAL ECONOMIC & MARKET OUTLOOK
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FOCUS NOTES

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ECB: TLTROs, covered bond and ABS purchases; intermediate steps towards full-blown QE

- We are sceptical about the ability of the announced ECB's measures to facilitate credit easing, as they do not address banks' most pressing concern, which is capital adequacy.
- TLTROS, senior ABS purchases and covered bond purchases facilitate funding conditions but they do not improve meaningfully bank's capital position.
- Purchases of mezzanine ABS tranches would facilitate banks to offload credit risk and free up capital. However, euro area authorities seem reluctant to back high risk tranches with guarantees that would allow the ECB to buy them.
- Furthermore, ECB's ambitions to increase its balance sheet by €1tn may be constrained by the limited size of the ABS market.
- Strict regulatory proposals for securitized assets discourage both issuance and investment in ABS, limiting the clout of ECB's purchases to revive the ABS market.
- Given the downside risks to our economic and inflation outlook, it is more likely than not that the ECB will include public debt in its asset purchases program. However, this remains a close call, given fierce opposition to debt monetization.

Given the disappointing economic data and long -term inflation expectations (as measured by the 5-year inflation swap 5 years ahead) falling below 2%, the ECB has announced an asset purchase program. The program consists of purchases of private sector assets, including asset backed securities (ABS) and covered bond issued by European banks. With respect to ABS, President Draghi has further specified that the ECB will target simple and transparent euro-denominated securities, including residential mortgage backed securities (RMBS). The ECB intends to increase its balance sheet by about €1tn through the combined effect of the asset purchases and liquidity provision through the T-LTROs, announced in June.

The announced asset purchase program is seen as the ECB's first attempt to implement quantitative easing (QE). Unlike the situation with other major central banks which embarked on a large-scale QE program including purchases of both private and public sector assets, quantitative easing remains a controversial issue among the euro area policymakers. Dissenters perceive purchases of private sector assets as transfer of risk form banks to taxpayers and purchases of government bonds as debt monetization.

In what follows, we express our skepticism over the clout of the program to boost economic activity and inflation through the credit channel. As a consequence, we argue that if economic conditions and long-term inflation expectations take a turn for the worse, the ECB may have to embark on full-blown QE, including public debt in its basket of asset purchases.

Our first concern is that the asset purchase program announced may not really target capital adequacy issues, which is banks' biggest constraint. Banks use securitization mainly for two purposes: funding and credit risk transfer. Senior ABS tranches (i.e. s tranches that carry the smallest risk as they are paid before anything is paid to subordinated tranches) are predominantly used as a means of funding (e.g. via posting them as collateral in the ECB's operations), while the benefit of riskier mezzanine and junior (or equity) tranches is to off-load credit risk. The ECB intends to buy senior tranches of ABS, with mezzanine tranches being purchased only if the latter bear a guarantee by a public entity.

However, the German and Dutch ministers of finance have openly rebuffed the idea of attaching public guarantee to ABS tranches. French officials have also expressed reservations. If the ECB buys only senior tranches, it will just provide banks with another means of funding relief. Liquidity, however, is not the most pressing problems banks face, as was evident by the limited take-up in the first TLTRO (€82.6bn). The success of the ECB's program to spur credit extension depends crucially on the purchase of higher risk tranches, as these are the ones which enable credit risk transfer and free up large amounts of capital on banks' balance sheets.

As a second point of concern, regulatory issues may hamper the development of securitization as a means of funding and risk transfer. Onerous capital charges proposed by the Basel Committee penalize ABS, burdening them with heavier risk weights relative to other asset classes of similar risk characteristics. An example is given in Table 1, which presents risk weights of senior ABS and those of covered bonds, which, in general, have comparable risk profiles. The ECB and BoE in a joint discussion paper[1] highlight this discrimination and argue that a less punitive regulation for ABS assets would benefit the resuscitation of the ABS market.

Table 1
Risk weights of covered bonds and senior ABS tranches

	AAA	A	BBB	BB	B	CCC
Covered Bonds*	10%	20%	20%	50%	50%	100%
Senior ABS**	15%	50%	90%	160%	310%	460%

Notes: *risk weights under CRD IV, effective from January 2014. **Risk weights proposed by Basel Committee of Banking Supervision
Source: BCBS Revisions to the Basel Securitisation Framework, December 2013, CRD IV.

Tough regulation discourages either issuing or investing in ABS. Strict capital requirements lead investors to require high yields for ABS assets, rendering ABS a rather expensive alternative of financing for banks. At the same time, they discourage investors from holding sizeable quantities of ABS.

Strict regulation comes as a reaction to the impact of subprime RMBS in the US. Nonetheless, ECB executives have repeatedly pointed[2] out that punitive regulation is in sharp contrast to default rates of European ABS, which were considerably lower than those of their American counterparts (Table 2).

Table 2
Default rates of ABS by collateral; % of ABS outstanding in mid-2007 that have defaulted by end 2013

European ABS		US ABS	
Credit cards	0.00%	Credit cards	0.07%
RMBS	0.12%	RMBS	22.05%
Consumer ABS	0.13%	Autos	0.04%
SMEs	0.41%	Student loans	0.34%

Note: senior and non-senior tranches are included
Source: AFME, "High-quality securitisation for Europe. The market at a crossroads", June 2014

Risk weights for securitized products are still in consultation phase, with final weights expected to be published in H1 2015. Uncertainty over the final regulation acts against a speeded revival of the ABS market, auguring bad for an imminent positive impact on credit extension.

Likely restriction of ABS purchases to senior tranches and regulation uncertainty may curtail the clout of the ECB's purchase program to support the economy through the credit channel. Instead, asset purchases could bolster the economy and inflation through increasing nominal demand and exerting downward pressure on the euro. Yet, the limited size of the ABS market could constrain the effectiveness of the ABS purchases to kick-start inflation through these channels.

At its peak in 2007, European ABS issuance amounted to €818bn. After the eruption of the subprime crisis in the US, the market has all but stopped. Total issuance in the first half of 2014 amounted to a meagre €114bn (Figure 1). Demand for ABS shrunk sharply due to concerns about the quality of the underlying collateral. Additionally, dysfunctional inter-bank lending reduced demand for ABS as collateral in repo agreements, while the ECB penalized them by imposing high haircuts on ABS used as collateral in its liquidity provision operations. Moreover, traditional buyers of ABS, such as insurance companies, refrained from investing in the asset class due to harsh capital requirements.

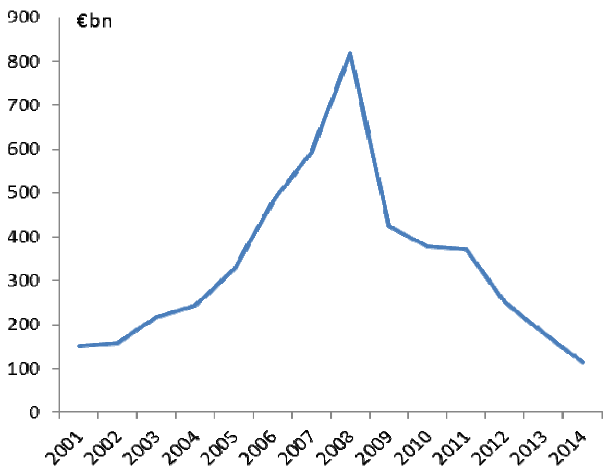
The outstanding amount of ABS as of Q2 2014 is €1389.1bn. Of this amount, only €104bn are backed by loans to SMEs, the category of firms the most dependent on bank lending. That explains the inclusion of RMBS in the basket of the ECB's purchases program, as this category is by far the largest, amounting to €824.6bn.

However, the amount eligible for purchases is much less than the total amount mentioned above (€1389.1bn). President Draghi mentioned that the ECB will buy simple and transparent, euro-denominated assets. Therefore, we subtract securities issued by

[1] ECB, BoE "The case for a better functioning securitization market in the European Union", discussion paper, May 2014

[2] See for example the speech by Yves Mersch "Banks, SMEs and securitization" , 7 April 2014

Figure 1
European ABS issuance



Note: data for 2014 refer to first half of the year
Source: AFME

the UK, as well as commercial mortgage-backed securities and CDOs. The new amount is about €850bn. 48% of it is placed, while the remaining ABS are retained by banks that issued them. Most of the retained assets are used as collateral in the ECB's operations. Moreover, if the ECB bought retained assets, it might have to buy them below par due to collateral deterioration, resulting in losses for banks. As a consequence, the ECB may opt for placed ABS, reducing the available assets down to about €408bn. Assuming that 85% of ABS are senior and no public guarantees to subordinated tranches, the final amount of ABS eligible for purchases is shrunk to about €350bn. According to the literature[3], this may not prove a comfortable amount to raise inflation close to 2%.

Besides the small size of the ABS market, other considerations raise questions over the ECB's ability to expand its balance sheet by about €1tn in period ahead. First, a spectacular increase in ABS issuance in the course of 2015 so as to increase available assets for purchase is unlikely due to regulation uncertainty, as explained above. Moreover, the impact of T-LTROs on the size of the balance sheet is expected to be limited, not least because about €366bn of remaining liquidity extended through the first round of LTROs are coming due early next year. Finally, it is not certain that the ECB will be able to buy a material amount of covered bonds due to limited availability in the primary market[4].

Given the above considerations, downside risks to our economic and inflation outlook and the narrowing down of available options, chances of the ECB including public debt in its asset purchases program have increased substantially. President Draghi stated in front of the European Parliament that the ECB stands ready to use additional unconventional instruments and alter the size and the composition of its unconventional interventions if inflation expectations fail to improve. Nevertheless, we acknowledge that full blown QE remains a close call, given fierce opposition to debt monetization.

[3] See for example Altomonte C., Bussoli P. (2014) "Asset-backed securities: The Key to unlocking Europe's credit markets", Bruegel
[4]The decline in the supply of covered bonds was a reason for which the ECB suspended its 2nd covered bond purchase program in October 2012).

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