The ECB Takes Further Steps to Support the Banking System; Stands By "To Do More"

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In another attempt to mitigate the economic fallout from the Corona pandemic, the European Central Bank decided on Thursday to take further policy easing measures. These measures primarily consist of a sizable liquidity facility for banks and additional easing of the financing terms for existing liquidity facilities. For all practical purposes, these actions are tantamount to an interest rate cut. Although the Governing Council refrained from stepping up its asset purchases at this juncture, ECB President Lagarde went out of her way to stress the central bank's readiness "to do more," if needed. **Still, the decision to refrain from including "fallen angels" in the corporate bond purchase program may serve as a disappointment to some investors.**

Following the announcement, which came on the same day that the eurozone reported a sharp contraction in first-quarter economic activity, Europe's STOXX 600 Index closed 2.0% lower, the 10-year Bund yield fell 9 bps to -0.59%, Italy's 10-year yield rose 3 bps to 1.76%, and the euro weakened by about 0.50% against the U.S. dollar.

The announcement of an additional liquidity scheme, namely the pandemic emergency longer-term refinancing operations (PELTROs), was the key measure announced on Thursday. A series of seven refinancing operations will commence in May and will consist of full allotments and fixed-rate tenders. **They are intended to incent banks to take advantage of the recent collateral easing, and, thus, aim to facilitate access to refinancing for banks that are short on investment grade collateral.**

As such, these measures signal a concern about the trajectory of banks' asset quality as the economic fallout deepens and provide a platform that could quickly be expanded upon in case of substantial ratings downgrades. The measures also indicate that the banks need a further push to lend. **It goes without saying, all eyes remain on Italy, although rating agencies have deferred a decision on the sovereign's investment grade status until more can be determined about its post-crisis policy path.**

At current policy rates, the PELTRO tenders will carry a rate of negative 25 bps. This rate could presumably be readily lowered, as highlighted by Thursday's decision to further improve the financing terms of the existing TLTROIII liquidity schemes; **under the revised terms, TLTROIII rates can now go as low as negative 1 percent—in other words, the ECB is handsomely paying banks to lend!**

Clearly, the ECB is intensively focused on preventing a possible seizing up of credit markets. The acceptance of sub-investment grade collateral combined with negative interest rates on large-scale liquidity operations should go a long way to achieve this objective. However, despite an effective interest rate subsidy, **concerns about corporate insolvencies are likely to temper banks' appetite for lending**. Such risks, of course, are intended to be addressed through the credit guarantees that are now commonplace across the eurozone.

Most importantly, however, the ECB stands ready "to do more." In a telling answer President Lagarde pointedly sidestepped yield curve control, **but came remarkably close to linking the ECB's asset purchases to sovereigns' large-scale issuance needs**. In this context, she once more emphasized the ECB's readiness "to do more," implicitly suggesting the ECB's Pandemic Emergency Purchase Program (PEPP €750 billion) could be extended beyond its currently envisaged end into next year, seemingly acknowledging that fiscal deficits and related funding needs are likely to remain sizeable for the foreseeable future.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of April 2020.

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