

Bank supply hurdles to rise further in 2021

Banks have relied far less on bond market funding this year than in 2019 due to the Covid-19 crisis. Solely subordinated supply has kept its head above water thanks to the ECB's measures. With the global economy in the process of recovering from its severe growth relapse, 2021 bank supply is likely to follow a similar pace we've seen this year



Frankfurt's banking district

Primary market activity

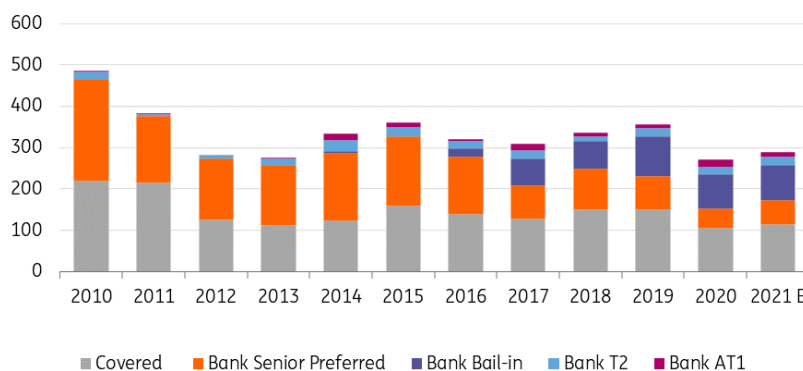
The primary market activity in bank bonds has been very slow this year from a historical point of view. While last year's supply reached €357bn, all debt categories included, only €237bn has been issued by mid-October in 2020 and we forecast supply to reach €272bn by the end of the year, as you can see in the chart below. Considering our 2020 forecast, we estimate the overall supply in 2020 to decrease by around 25% compared to what has been issued by banks in 2019. The drop is particularly noticeable within the covered and preferred senior bond categories. As a matter of fact, €91bn had been issued by mid-October in covered bonds and €41bn in preferred senior. We forecast covered bond supply to reach €105bn by the end of the year, a substantial decrease compared to €151bn in 2019. We expect preferred senior supply to total to €47bn at the end of 2020 while €81bn was issued last year.

Primary market activity in bank bonds has been very slow this year

€72bn had been issued in bail-in senior bonds up until mid-October, leading us to estimate this supply to rise to €83bn by the end of the year, still lagging the €95bn issued in 2019. Only the subordinated segment seems to be slightly running ahead of last year with a total of €33bn issued up to mid-October, comprised of €16bn of Tier 2 and €16bn of AT1 bonds, versus €31bn for the whole year 2019 (€21bn of Tier 2 and €10bn of AT1 bonds).

These supply dynamics can be explained by different factors. Firstly, the decision of the ECB in March allowed banks to meet part of the Pillar 2 requirement with AT1 and Tier 2 instruments on top of covering 56% of the P2 requirement with CET1 instruments. This could be one factor supporting a rise in AT1 supply compared to last year. Secondly, subordinated issuance may have been supported by a rise in lending growth for some banks. Eventually, the combination of ample liquidity, negative underlying yields and tight spread levels created a supportive environment for banks to print capital. All in all, we estimate subordinated supply to reach €37bn in 2020 (€19bn of T2 and €18bn of AT1).

Bank supply and estimates (€bn)



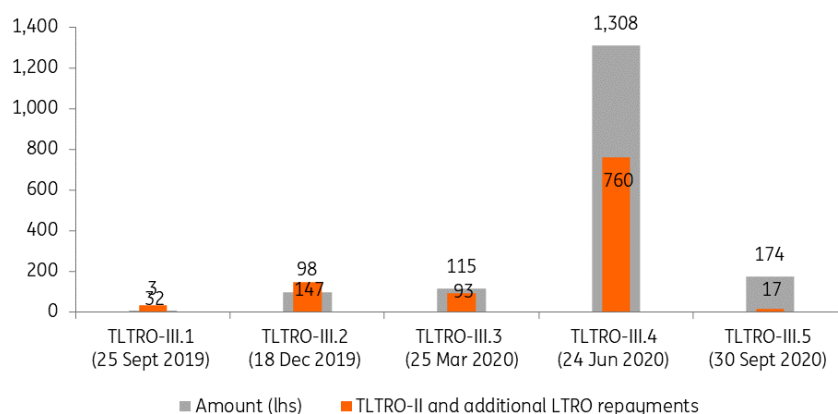
Source: ING, Dealogic

Bank redemptions amount to €291bn in 2021, of which €143bn is in covered bonds, €103bn in preferred senior, €13bn in bail-in senior, €25bn in Tier 2 and €7bn in AT1. The 2021 redemptions are slightly higher than in 2020 (€291bn versus €289bn), and we do see a rise in covered bond redemptions (€134bn in 2020 versus €143bn in 2021) and in bail-in senior redemptions (€2bn to €13bn). Within the subordinated bonds bucket (bonds with a first call date or a maturity date), Tier 2 and AT1's redemptions total €32bn in 2021 versus €36bn in 2020. Tier 2 redemptions decrease from €27bn in 2020 to €25bn in 2021 and AT1 redemptions from €9bn to €7bn.

French banks have widely dominated the supply by banks in EUR this year

Although not graphically shown here, French banks have widely dominated the supply by banks in EUR this year. The French banks had issued a total €64bn, all debt categories included, until mid-October. Germany takes second place with €25bn, followed by Spain (€22bn) and Italy (€21bn). Banks in these four countries are also the largest users of the Targeted Longer-Term Financing Operations (TLTRO). France and Italy drew respectively €350bn and €345bn in June, while German and Spanish banks drew €248bn and €257bn respectively from the fourth tranche, which was the largest TLTRO tranche to date.

TLTRO-III allotments vs TLTRO-II repayments (€bn)



Source: ECB, ING

The role of the European Central Bank

The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB. European banks have in effect attracted a sizeable €1,308bn under the fourth tranche of the ECB's TLTRO-III operations in June and €175bn under the fifth one in September, as we show above, totalling to a substantial €1,699bn central bank funding so far. A large number of banks participated in the fourth tranche (742) while a little more than half of this amount of bidders drew funds under the fifth tranche, as shown in the chart below.

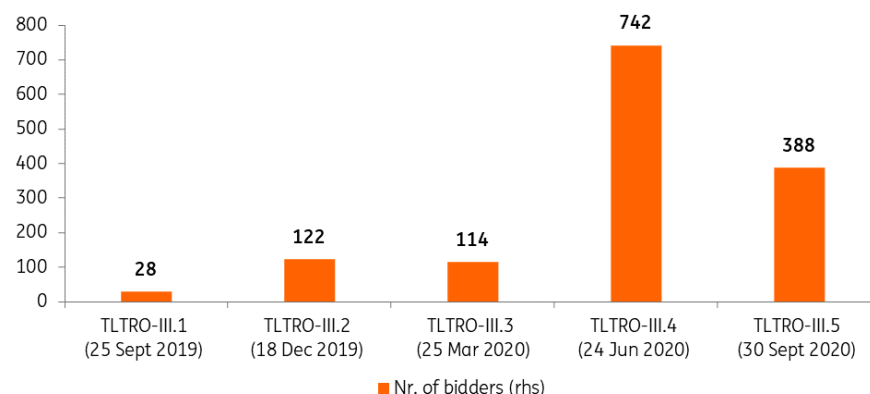
The fall in covered bond and preferred senior supply is a direct consequence of banks relying more on the ECB

This also suggests that still many banks participated in that tranche, but drew a substantially lower amount. If banks meet the lending requirement set by the ECB, they can obtain the TLTRO funding at a rate of -1% for one year and at -0.50% for the rest of the time. The banks still have two more opportunities to draw funds under the TLTRO-III operations on 16 December 2020 and 24 March 2021. The last date is also likely to see some large withdrawals as it is the final opportunity.

September 2021 brings the first early repayment opportunity for the first five tranches. The sixth and seventh tranches have their first early repayment date on 22 December 2021 and 30 March 2022 respectively. As we mentioned earlier in our [European banks, Do they have what it takes?](#) report, the willingness for early repayment may depend on the lending development of the

bank, the secondary bond trading levels, the tiering effects and the economic outlook.

TLTRO-III number of bidders



Source: ECB, ING

Early repayment considerations

Furthermore, the measures taken to ease the leverage ratio calculation, the ECB's temporarily eased collateral rules and the net stable funding ratio (NSFR) are also important for banks to consider should they wish to repay their TLTRO-III debt earlier.

The first one relates to whether the ECB will decide in June 2021 that central bank reserves will remain exempted from the leverage ratio for another year. If central bank reserves remain exempted, banks will have less incentive to repay their TLTRO-III borrowings as the (partially) related higher central bank reserves will not weigh in the leverage ratio calculation.

Keep in mind the temporary nature of the eased ECB collateral rules in response to Covid-19

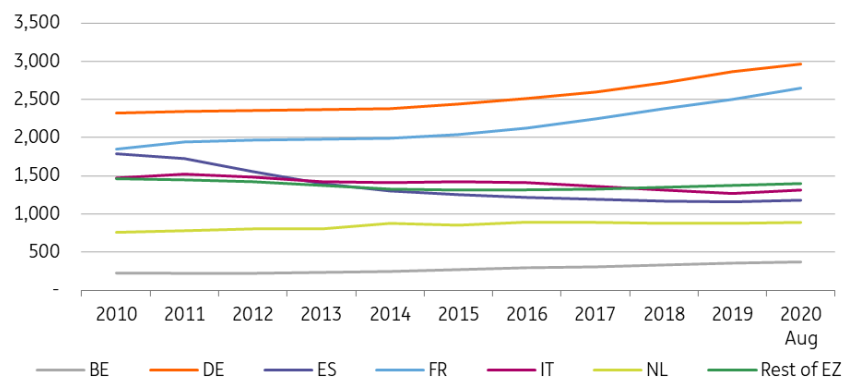
Another thing to bear in mind is the temporary nature of the eased ECB collateral rules in response to the Covid-19 pandemic. Last April, the ECB announced a temporary easing of the collateral measures linked to the duration of its Pandemic Emergency Purchase Programme. The PEPP is set to last until the Covid-19 crisis is over but should, in any event under its current terms, not be terminated before June 2021. The measures will also be reassessed before the end of the year. If the period of the eased collateral rules expires, banks will have less eligible collateral available vis-a-vis their sizeable TLTRO drawings.

Eventually, the Net Stable Funding Ratio will become binding by 28 June 2021, meaning that banks will have to comply with the requirements. TLTRO funding is fully eligible as stable funding up to one year ahead of their maturity. Hence the fact that the NSFR will be binding in Europe as of next year will likely weigh more heavily in the decision by banks to repay their TLTRO fund early than it has before.

Corporates and households

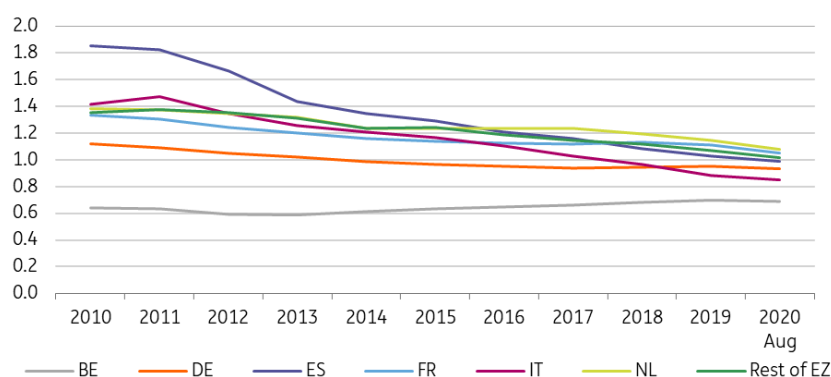
The chart below shows that bank lending growth is stronger in some countries than others: Germany and France take the lead, with comfortably rising loan books. Italy and Spain record both a slight recovery after years of decreasing loan books. The rest of the eurozone banking sectors have flatter lending growth curves.

Bank lending growth (€bn)



Source: ECB, ING

Loan to deposit ratio



Source: ECB, ING

That being said, for the corporates and household segments alone, the loan to deposit ratio has plunged over the years, as you can see in the chart above. This illustrates that banks accumulate deposits at a higher pace than their lending. Especially this year, with the Covid-19 outbreak, the drop in consumption and the lockdowns have resulted in households saving more money than usual. Corporate deposits also recorded strong growth across all eurozone jurisdictions, thanks to borrowings that companies have put in as deposits for future use. This has mitigated the need for banks to finance their lending growth with the issuance of new bonds.

Our economic scenarios

Different economic scenarios have been assessed by our economists in their [Monthly Economic Update](#) of October. Scenario 1's assumptions, which is also our base case, focus on local

lockdowns, mild national restrictions and several vaccines being available in 2021. Scenario 2 depicts a darker picture with restrictions tightened, a handful of viable vaccines but with a different roll-out in 2021 across economies. Scenario 3 portrays a gloomy economic environment resulting from national lockdowns in which the vaccine development takes longer.

The 2021 bank supply should not be that different from what we have seen this year

Whichever scenario we face next year, the 2021 bank supply should not be that different from what we have seen this year. That said, if we are looking at scenario 1 or 2, 2021 supply may run slightly ahead of 2020. If scenario 3 appears to be the reality next year, supply is more likely to be fairly in line with this year and we would expect heavier ECB support and more TLTRO drawings with the possibility of the ECB extending the period during which banks may benefit from the currently applicable -1% TLTRO funding rate. A prolonged duration of scenario 2 could also lead to the same assumptions as explained in scenario 3.

€290bn Bank supply in 2021

Overall bank supply

Following our base case scenario, we believe the 2021 overall bank supply will run ahead of 2020 but we expect it to remain modest and certainly not to exceed 2019. Covered bond supply is expected to rise from €105bn to €115bn and preferred senior issuance from €47bn to €58bn. For covered bonds, the rise can in part be explained by the €9bn increase in redemption payments in 2021. Since the supply in covered bonds and preferred senior paper has seen the strongest decline in 2020 on the back of the ECB's TLTRO-III operations, we expect this issuance to pick up again as we believe that at least some banks will decide to repay their TLTRO drawings earlier in September next year after the interest rate on those drawings has been reduced from 100bp to 50bp. This will free up encumbered assets in support of the issuance of covered bonds. Besides, covered bonds and preferred senior will remain the most favourably priced instruments to replace the shorter maturity TLTRO funds with longer maturity bonds.

Bail-in senior issuance is expected to be roughly in line with this year's issuance, at €85bn. A couple of factors are to be considered here: the rise in redemptions and the fact that some banks are already well advanced in terms of meeting their Minimum Requirements for own funds and Eligible Liabilities (MREL), while other banks are still in the process of building up their MREL buffers.

The favourable market conditions, the decision of the ECB to meet part of the P2 requirement with Tier 2 and AT1 bonds and the fact that banks may replace their grandfathered Tier 1 by 31 December 2021 will all remain supportive factors to the issuance of subordinated paper. Nonetheless, we do expect subordinated supply to fall slightly compared to this year's forecast as banks will have less subordinated debt to refinance in 2021 (€36bn repaid this year versus €32bn in

2021). Hence, banks will ultimately also make an economic decision regarding their need to attract subordinated debt versus cheaper alternatives. Should the ECB decide to continue to restrict dividend payments, the net subordinated issuance should not be expected to rise that much compared to this year. Considering all these factors, we estimate Tier 2 supply to remain relatively stable at €20bn and AT1 supply to fall to €12bn.

Bank supply and redemptions and ING forecasts (€bn)

	2019	Mid-Oct 2020	ING end of 2020 forecast	2020 redemptions	ING forecast 2021	2021 redemptions
Total	357	237	272	289	290	291
Covered bonds	151	91	105	134	115	143
Bank senior unsecured	176	113	130	119	143	116
o/w Preferred senior unsecured	81	41	47	117	58	103
o/w Bail-in senior unsecured	95	72	83	2	85	13
Bank subordinated debt	31	33	37	36	32	32
o/w Tier 2 debt	21	16	19	27	20	25
o/w Additional Tier 1 debt	10	16	18	9	12	7