ECB decision time: For banks, more deposit tiering as low TLTRO rate ends

By June 2022, the favourable borrowing rate on the Eurosystem's TLTRO operations will end and we do not expect an extension. To somewhat mitigate the considerable impact on eurozone banks, we expect the ECB to tweak the deposit tiering multiplier until policy rate hikes arrive in 2023

The ECB headquarters in Frankfurt

The end of TLTRO favourable rates is moving into view

What's to become of the TLTROs, the Targeted Longer-term Refinancing Operations? They're likely to be on the table at the 'big bang' meeting and the Eurosystem will particularly be looking at the expiry of the -100bp favourable rate on 23 June 2022. To mitigate the impact of this expiry on banks, we expect an increase to the deposit tiering multiplier (set at the initial value of 6 in September 2019, and not modified since), until the deposit facility rate returns to zero (which we expect to happen in late 2023), removing the need for such measures.

This is a rather complicated story, so bear with us. The rate on banks' TLTRO borrowing from the ECB has been made dependent on their lending to the real economy, in particular to businesses. If lending exceeds a benchmark, banks qualify for a borrowing rate as favourable as -100bp. The last favourable rate period runs from July 2021 to June 2022. Unless the ECB announces new modifications to TLTRO conditions (which we do not expect), the borrowing rate will increase to, at best, the deposit facility rate which is currently -50bp.

The end of the favourable TLTRO rate would lower Eurozone banks' negative rate revenues by about €950m per month

Banks have, especially over the past 1.5 years, borrowed significant amounts under the TLTRO. The ECB currently has €2287bn of TLTRO loans outstanding (note that the tenth and last tranche is concluded next week, with allotment announced on 16 December; we expect this to be one of the smaller tranches). The end of the favourable TLTRO rate would lower TLTRO negative rate revenues for eurozone banks by about €950m every month. That significant change in itself might already be a reason for the Eurosystem to take a look.

But there's more. Ending the TLTRO favourable rates brings back another issue: the considerable negative rate costs imposed on the banking system by the Eurosystem's asset purchases. This requires some explanation.

? How Eurosystem asset purchases cause reserves that banks cannot avoid

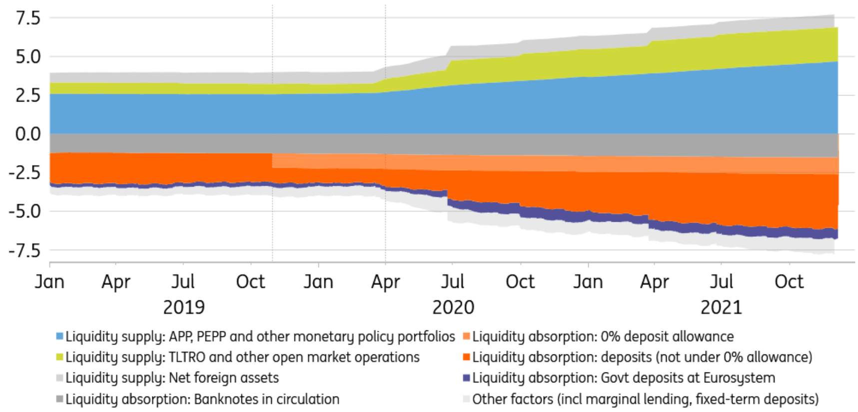
Both ECB TLTRO loans and ECB asset purchases necessarily lead to increased deposits (or "reserves") held by commercial banks at the ECB. This is a simple consequence of double-entry bookkeeping: both TLTRO loans and asset purchases increase the Eurosystem's assets, and increased deposits are the corresponding Eurosystem liability that increases in tandem. These Eurosystem deposit liabilities, or bank reserves, have carried a negative deposit facility rate charge of -50bp since September 2019.

Insofar as Eurosystem deposit liabilities are caused by asset purchases, the banking sector has no way to avoid them. An individual bank may try and reduce its reserves, for instance by substituting into bonds. But this will only offload reserves to another bank. Total reserves in the system are a given for banks. The collective banking sector cannot avoid or reduce these reserves, because the Eurosystem drives them with their asset purchases.

The unavoidable nature of reserves does not apply to those reserves that are created by TLTROs. In those cases, banks deliberately choose to take out a TLTRO loan. The associated reserves may and do however end up at other banks.

Back in 2019, the ECB acknowledged that imposing a negative rate on reserves that the banking sector cannot avoid may not be fair. Hence the ECB implemented a "deposit tiering multiplier". Initially set at 6, this means that since late 2019, an amount of 6 times required reserves, plus required reserves themselves, are exempt from negative deposit facility rate charges. When this tiering came into force, it reduced the negative rate cost of bank reserves by about €350m each month. See the light orange area in the chart below, and this article for more on involuntary reserves and deposit tiering.

Eurosystem liquidity supply and absorption (€ trillion)



Source: ECB, ING-calculations

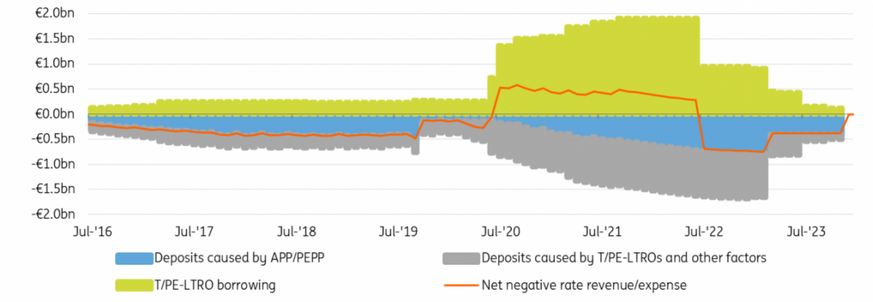
Since late 2019, both Eurosystem asset purchases and TLTRO lending have increased dramatically. Bank reserves have increased with them by an eye-watering 145%, from about €1850bn in October 2019 to over €4500bn today (see the orange area in chart). The increased reserves have driven up negative rate expenses for banks. Yet these are, in aggregate, more than compensated by the favourable -100bp borrowing rate that most banks will qualify for. The ECB did not, therefore, think it necessary to revisit the deposit tiering calibration, even though the aggregate numbers hide substantial redistributive effects between eurozone banks, as both TLTRO borrowing and reserve holdings differ (we describe the redistributive effects here).

Moreover, this constellation of policies did muddy TLTRO goals: apart from their official goal to "preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy", TLTROs have simultaneously become an instrument to mitigate the negative rate costs imposed on banks as a result of asset purchases.

From a €300m monthly net gain to a €700m monthly net loss in July 2022

The mixing of TLTRO policy goals becomes a problem when, in July 2022, the favourable TLTRO borrowing rate ends. Extending the favourable rate may not be needed to stimulate bank lending, but what about the hugely increased asset purchases and the much higher negative rate cost the associated reserves impose on banks? These have gone from a monthly €120m after tiering was enacted in late 2019, to over €500m per month now, and may surpass €700m/month in July 2022. That's shown in the blue area in the chart below. The chart also shows the other negative rate revenues and expenses for the eurozone banking sector, under our base scenario of tapering after March 2022, and a first deposit facility rate increase in the first quarter of 2023, and furthermore assuming no net changes to TLTRO holdings compared to today (except for redemption at maturity).

Eurozone banks' monthly negative rate expenses and revenues on ECB reserves and TLTROs



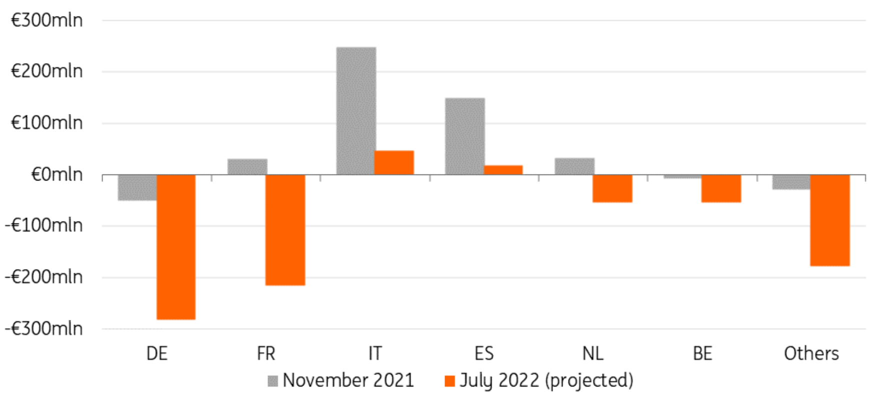
Source: ECB, ING-calculations

The monthly negative rate costs of reserves (the blue plus grey areas in our chart) are currently more than compensated by TLTRO borrowing rate revenues which are shown in the green area. This results in a projected monthly net negative rate revenue of €300m in June 2022 (the orange line). When the TLTRO favourable rate ends and no other measures are taken, the net monthly result abruptly turns negative to the tune of -€700m.

Some banks will be hit harder than others

Given the uneven distribution of TLTROs borrowing and reserve holdings over eurozone countries, some banks will be hit harder than others. The Italian and Spanish banking sectors manage to just keep net positive negative rate revenues, while banking sectors in Germany, France, Netherlands Belgium and elsewhere start to incur negative rate net costs again. Upon our assumed 25bp increase in the deposit facility rate in the first quarter of 2023, net negative rate costs halve.

Monthly net negative rate revenue/expense per country



Source: ECB, ING-calculations

What the ECB could do to dampen the impact in July 2022

We made some further calculations to see what changes to the deposit tiering framework would be needed to mitigate the impact of the end of the -100bp favourable TLTRO rate on banks. The change in the multiplier needed to fully undo the aggregated impact would not qualify as just a tweak. Even doubling the multiplier, from the current 6 to 12 times required reserves being exempt from negative rates, would leave banks barely in a better position than where they were in September 2019. Note that the ECB should not be satisfied by just restoring the September 2019 situation in terms of costs imposed on the banking sector, because that is when the ECB decided to start deposit tiering in the first place.

> *Even under a multiplier of 15, some banks would continue to incur significant net negative rate costs*

We can also calculate the multiplier that would reduce negative rate costs to what they were in the last quarter of 2019 under the assumption the ECB considered them satisfactory. These amounted to €125m/month. To get there, the tiering multiplier would need to be cranked up to 15. That sounds like a lot, and it is, but it would still exempt only half of ECB reserves of negative rates. It is also important to note that this tiering would reduce, but not eliminate the redistributive effects of the negative deposit rate. Even under a multiplier of 15, banks in e.g. Germany and France would continue to incur significant net negative rate costs, while those in Italy, Spain, Portugal and Greece would continue to make net negative rate revenues. This is due to the fact that banks in the latter group would continue to receive the full -50bp negative rate on their TLTRO borrowing, while some of the corresponding reserves have ended up with the former group, absorbing the -50bp deposit rate. There is little that generic deposit tiering can do about this.

A tweak to the deposit tiering multiplier as a temporary fix

As the favourable TLTRO rate expires in June 2022, eurozone banks face a strong hike in negative rate costs. This will last until the deposit facility rate is increased to zero, which we pencil in for the end of 2023. In the meantime, we don't expect a prolongation of the favourable TLTRO borrowing rate. The deposit tiering multiplier is the easiest tool for the ECB to turn to, but it has its shortcomings. For one, it would need to be increased very significantly to fully compensate banks. It would also leave the sizeable redistribution among eurozone banks unaddressed as some of the funds borrowed under TLTROs have been flowing from southern Europe towards the north. This will self-correct when TLTRO funds are repaid which will take time (the last TLTROs are scheduled to mature in 2024).

With deposit facility rate increases emerging on the horizon, the negative rate costs imposed on banks by the ECB's asset purchases will be of a temporary nature. We, therefore, expect the ECB to settle for a modest deposit tiering multiplier increase only, from 6 to 10. This will fall far short of compensating the increase in net negative rate costs many banks will experience, but will at least remove the sharpest edges. It would lower negative rate costs for northern eurozone banks by about 25%, compared to the no-multiplier-tweak scenario depicted in the chart above.

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