ECB support for bank funding remains...for now

Bank funding remains strongly supported by the ECB. We don't expect the TLTRO terms to be eased any further, and we believe banks will start refinancing their TLTRO-III drawings in 2022. We expect early TLTRO repayments to peak in June 2022

European Central Bank Governing Council meeting, Frankfurt Am Main, Germany - 28 Oct 2021

Source: Shutterstock

The TLTRO-III operation has been a success, especially when measured by its popularity among banks

The European Central Bank (ECB) launched the **third series of targeted longer-term refinancing operations (TLTRO-III)** for banks on 7 March 2019. The operations build on two previous series that were launched in 2014 and 2016. The TLTRO aims to provide attractive funding conditions for banks to support lending to the real economy. The interest rate of the funds may be as low as -1% between June 2021 and June 2022 and is being tied to requirements that banks meet the corporate and household (excluding house purchases) lending growth requirements in the Eurozone set by the ECB.

TLTRO-III is an important part of the bank funding equation

We consider the TLTRO-III operation an important part of the bank funding equation. While we don't expect banks to have to refinance all of their TLTRO funds, we do consider refinancing part of the TLTROs to result in a higher bank bond supply during the course of 2022.

The operation has been a success, especially when measured by its popularity among banks. European banks have drawn a total of €2,287bn from the TLTRO-III via nine tranches. By far the largest tranche to date was the fourth, which was allocated in June 2020, when 742 banks took €1,308bn from the operation. According to the October bank lending survey, the TLTRO funds have been used especially for granting loans, which has also been an ECB objective.

€2,287bn Initial size of the TLTRO-III operation

TLTRO drawings in December to remain limited

One more tranche in TLTRO-III remains with its allocation scheduled for December 2021. According to the bank lending survey, only 12% of banks plan to participate in the December tranche, while 43% had indicated not to participate and 42% remained undecided.

> *We expect the December TLTRO drawings to remain limited*

We consider that the December TLTRO tranche will be amongst the smaller tranches. This is mainly driven by its availability, as most banks have already maxed out their TLTRO drawings. Banks that have some room in their TLTRO allowance, may seek to participate if they know that they will meet their lending objectives and are therefore able to take advantage of the most attractive -1% rate until June 2022, after which they can pay back the funds early if needed. Another reason to participate was outlined in the bank lending survey, where 12% of banks mentioned the fulfilment of regulatory or supervisory requirements as a motivation for future TLTRO participation. This probably refers to banks considering their NSFR compliance and the positive impact a longer TLTRO tranche could have upon it.

Secondly, rolling funds from previous TLTRO tranches are not attractive due to the strict conditions on the TLTRO rate setting. If a bank pays funds back early in the TLTRO tranches in December to refinance in the last 10th tranche, it will not be able to benefit from the additional special interest rate of -1% between June 2021 and the settlement date of the repayment. This is the case even if the bank theoretically meets the lending requirement, as these prepayments would take place before the lending data is transferred to the central bank and the interest rate is communicated to the bank. We consider this to be a strong incentive for banks not to roll funds at this stage to a longer tranche.

Drivers for an early repayment in December and March

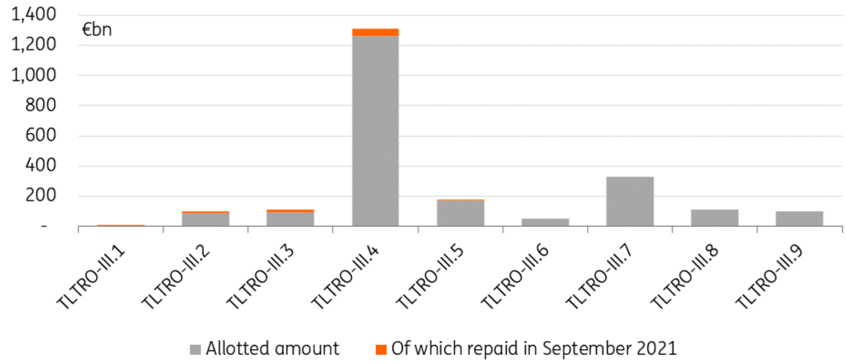
The TLTRO-III offers three-year funding with a chance to repay funds early. Since September 2021 banks can pay back drawings on a quarterly basis in tranches 1-7 as long as at least one year has passed since the settlement date of the tranche. Furthermore, after June 2022 banks can repay early funds from tranches 8-10 on a quarterly basis. The first early repayment option for the first five tranches was in September 2021, when €79bn was repaid.

Rollovers from previous tranches to remain limited in December

Our expectation for a limited rollover to the December tranche from previous tranches means that this factor should not be a large driver for early repayments in December. One reason for early repayments in December could be the inability to meet the lending targets, as the lending benchmark period ends in December 2021.

In addition, the temporary relief measure allowing for a deduction of central bank exposures from the leverage exposure measure calculation, is set to end in March 2022. The end of the relief could drive some banks to reconsider the impact of the TLTRO operation on their capital metrics, if they have substantial balances kept at the central bank. According to the ECB, the relief measure had a positive impact of 70bp on the leverage ratio of 39 significant institutions as of end-2020, and it improved the headroom to the leverage ratio requirement by 50bp. Some large banks have already stopped utilising the relief measure in their leverage ratio calculation.

TLTRO-III drawings vs repayments



Source: ING, ECB

Early repayments to peak in June 2022

The ECB has already extended the special interest rate period by one year. This period was first set to run from June 2020 until June 2021. Then the additional special interest rate period was introduced to run between June 2021 and June 2022. If the TLTRO terms are retained as they are now, the TLTRO rates will increase from June 2022 onwards.

TLTRO rates will increase from June 2022 onwards

For tranches 1-7, banks see their TLTRO rate to move, so that it is in line with the deposit rate (-50bp) if the bank has met either the lending benchmark on the special or the additional special reference period. In the case of meeting only the benchmark lending in the second reference period, banks see the TLTRO rate being tied to the average main refinancing rate adjusted for the lending development. In the case of banks not meeting any of the lending benchmarks, the TLTRO rate increases to be in line with the main refinancing rate (currently zero).

For tranches 8-10, banks that have met the lending benchmark by end-2021 will see the TLTRO rate move to the deposit rate (-50bp). For banks that did not meet this, a rate in line with the refinancing rate (currently at zero) is to be expected.

Banks that see their TLTRO interest rate hiked to be in line with the main refinancing rate, are more likely to pay back funds early. Instead, banks that continue to benefit from a rate in line with the deposit rate, are more likely to retain funds until maturity.

We expect to see a larger early repayment after the end of the additional special interest rate period in June 2022. This is also when the maturity of the bulk of the TLTRO-III funds, those drawn in June 2020, will turn shorter than a year and as such lose part of their NSFR recognition.

Potential ECB rate hikes would translate into higher TLTRO rates

While the ECB may keep the reference rates unchanged for the time being, rate hikes may be on the agenda in the second half of 2023. This will have consequences for the TLTRO programme as well with tranches 5-10 maturing during or after 2H23.

As the TLTRO interest rates are tied to the average reference rates during the life of the operation, a rate hike (or a rate cut) will be directly passed on to banks. Only in the case of the (additional) special interest rate period running until June 2022, has the ECB has confirmed that the rate can not be higher than -1% for those banks that meet the relevant lending requirements.

A rate hike would increase also the TLTRO interest rates

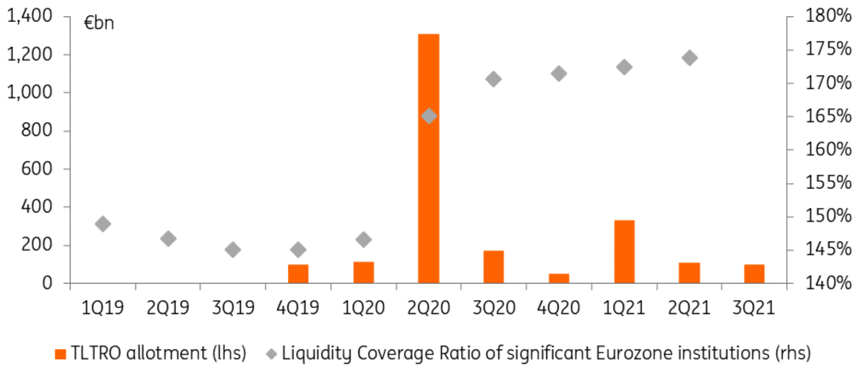
While a rate hike would not impact the most attractive TLTRO rate, this period ends in June 2022. After June 2022 any changes in both reference rates will directly reflect on the cost of the TLTRO for all banks.

The attractiveness of the TLTRO interest rates will always be benchmarked against the alternative, the price of issuing a bond. Bank bond yields have clearly recently risen, especially so for the covered bond segment, but also for preferred senior unsecured debt. This has resulted in the TLTRO rates being even more attractive than before. With the current bond yields, meeting one of the lending benchmarks would result in TLTRO funds looking more attractive than bond market funding. Furthermore, in the case of not meeting the lending benchmarks, the TLTRO rate may look attractive or at least break even due to the lengthy special interest rate periods.

An ECB rate hike is not likely to completely change this picture. Expectations for higher underlying rates also tend to push bank bond yields higher.

If the ECB did not want the expected rate hikes in 2023 to transform into higher TLTRO rates, it could change the terms by fixing the reference rates to be in line with the level during the allocation. It could also introduce another special interest rate period starting in June 2022, together with new tranches. Having said that, we consider that this would require the bank funding conditions to deteriorate considerably from the current levels, which is not currently our base case.

TLTRO drawings vs liquidity coverage ratio of significant eurozone institutions



We don’t expect action to avoid a cliff edge effect…for now

With the current relatively strong recovery and inflation outlook accompanied by the benign bank funding markets, we see limited reasons for the ECB to extend the current TLTRO-III operation by adding new tranches. The last tranche of the current operation anyway extends until the end of 2024, offering some soothing for the central bank considering any cliff-edge effect of the operations. Furthermore, worrying about the end of the operation before the last tranche is even allocated, seems premature to us.

Banks can draw up to 55% of their eligible loans, as of February 2019 from the operations. We consider that banks have more or less used their maximum capacity to draw funds. Therefore, new tranches would only be substantially used if they were launched after the current operation matured, were paid back early or if the capacity of banks to draw funds was increased. Introducing new tranches to the TLTRO-III anytime soon, seems premature. This is especially so in the current environment with substantial uncertainty around the temporary nature of inflation. Additionally, in this context, we consider that it would be as difficult to find solid reasoning for easing the terms via increasing the drawing capacity of banks.

Interestingly the recent bank lending survey concludes that despite a lower take-up in the last TLTRO tranches, the large outstanding amounts of TLTRO funds continue to support banks’ financial situation. This positive impact is expected to remain broadly similar over the next six months. This should act as a supporting argument for the ECB not to make changes in the current TLTRO programme anytime soon.

The Eurozone banks have utilised the TLTRO drawings to grant loans, but they have also gathered excess liquidity. The chart above shows that the liquidity position of the significant institutions in the Eurozone has improved hand in hand with the TLTRO drawings. This high liquidity is likely to support expectations that banks do not need to refinance all their TLTRO drawings.

Due to the high liquidity, not all TLTRO funds have to be refinanced

In addition, if the ECB does not extend the current TLTRO operation, we would not exclude the possibility of the ECB offering some support for the banking sector in the form of changes to the current tiering system. The tiering mechanism helps banks offset the impact of negative rates on their excess central bank reserves.

Leaving the TLTRO-III programme as it is, would translate into banks starting to refinance their TLTRO-III drawings in the course of next year. We would expect early repayments to peak in June 2022.

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