10 December 2020
Financials

# European banks

## The ECB comes with new gifts

**The ECB announced today a new package of monetary policy measures including an increase in the PEPP and changes to its bank funding programmes TLTRO-III and PELTRO. We take a look at the implications for banks and bank bonds.**

- As widely anticipated, the ECB today decided to increase the size of the pandemic emergency purchase programme (PEPP) by €500bn to €1,850bn. The programme will now at least be active until the end of March 2022. The extension and increase of the PEPP gives the ECB room to buy a further €72bn per month under this programme until the end of March 2022. The public sector purchases will, in our view, remain the most important focus area of the PEPP. Meanwhile, the monthly purchases of €20bn per month under the asset purchase programme (APP) will remain intact. As the €120bn envelope ends this year, these extra monthly APP purchases (also mostly public sector focused) could shift to the PEPP. **In terms of the ECB's monthly covered bond buying efforts, we don't expect that either the end of the €120bn envelope or the PEPP's expansion and extension will make much of a difference**.
- The ECB today announced that it will further recalibrate the terms of its third Targeted Longer-term Refinancing Operations (TLTRO-III) programme. Firstly, the special interest rate period is extended by 12 months to June 2022. Secondly, three additional tranches are to be added to the operation that will be conducted between June and December 2021. Thirdly, the total amount that banks can draw from the operations was increased from 50% of eligible loans to 55% of eligible loans. And lastly, in order to provide an incentive for banks to sustain the current level of bank lending, the recalibrated TLTRO-III borrowing conditions will be made available only to banks that achieve a new lending performance target of 0% between October 2020 and December 2021.
- We make following conclusions based on the TLTRO-III term changes: (1) the effect on **bank bond supply in 2021 is negative** due to a combination of the extended special interest rate period leading to smaller early prepayments of TLTRO-III in 2021 and new tranches providing new opportunities to increase TLTRO at the expense of bond funding, (2) the introduction of new tranches and the higher available amount per bank will together result in a **higher total size of the TLTRO-III programme** in 2021 and provide funding for banks until end-2024, this will further **limit bank bond supply in 2022**, (3) **bank earnings are supported** by the lengthening of the favourable TLTRO-III special interest rate period, which is especially beneficial in the current environment of lower for longer interest rates and (4) **reaching the new lending targets will likely to be more difficult than reaching the old lending benchmark targets.** While the levels are similar the substantial government measures in place have supported lending development this year, we consider that this effect may not carry into 2021 in a similar magnitude.
- **We lower our supply estimates for covered bonds and preferred senior unsecured in 2021 to €100bn and €53bn respectively, from €115bn and €58bn**. The lengthening of the special interest rate period for the TLTRO-III in combination with the addition of the new tranches and a higher TLTRO allowance per bank will together act as a limit for funding driven bank bond supply next year and well into 2022. The abundant amount of liquidity available at banks will, in our view, remain constructive to the performance of bank bonds in the first half of 2021.

**Suvi Platerink Kosonen**
Senior Sector Strategist, Financials
Amsterdam +31 20 563 8029
suvi.platerink-kosonen@ing.com

**Maureen Schuller, CFA**
Head of Financials Sector Strategy
Amsterdam +31 20 563 8941
maureen.schuller@ing.com

## ECB increases the PEPP by €500bn

As broadly anticipated, the ECB today decided to increase the envelope of the pandemic emergency purchase programme (PEPP) by €500bn to €1,850bn, while at the same time extending the horizon of the programme to at least the end of March 2022. The ECB confirmed that net purchases will be conducted under this programme in any case until the central bank judges the coronavirus crisis phase is over.

The ECB also decided to extend the reinvestments of redemption payments under the PEPP at least until the end of 2023. The future roll-off of the PEPP will be managed in a way to make sure any interference with the fitting monetary policy stance is avoided.

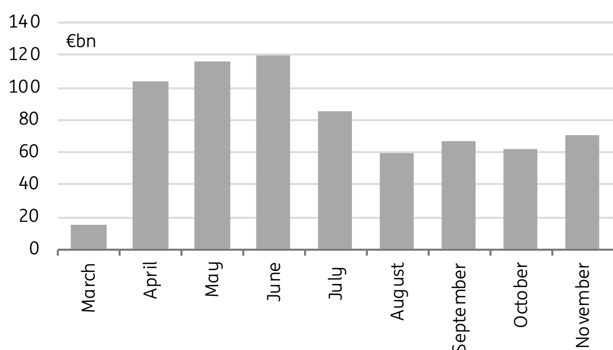
> *"The extension of the PEPP gives room to a stable purchase pace of €70-75bn per month until March 2020"*

Since the pandemic emergency programme was initiated in March this year, the ECB has bought €700bn under the PEPP (statistics up until the end of November). The expansion and extension of the terms of the PEPP gives the ECB room for monthly purchases under the PEPP to the tune of roughly €72bn per month, more or less similar to the November 2020 realisation. We do note, however, that the higher November number compared to the three months before, may already reflect some frontrunning in purchases ahead of the Christmas holidays.

The public sector segment is likely to remain the main beneficiary of this particular programme, also in light of the increased funding requirements in this segment as a consequence of the Covid-19 support measures taken by governments within the Eurozone. Covered bonds, for example have not been bought anymore under this programme since August, and even during the period March-July only a negligible €3bn in covered bonds were added to the ECB's portfolio via this particular programme.

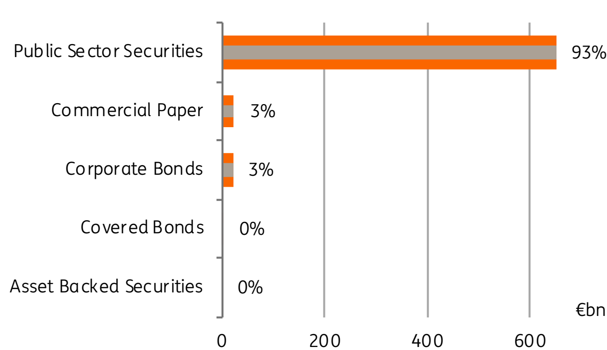
Asset backed securities, in turn, have not been bought at all under the PEPP, and corporate sector purchases have also become lower and lower, with only €342m bought in October and November. Besides, after adding €35bn in commercial paper during the March to May period, this portfolio has shrunk since to €24bn in November.

**Fig 1 €60-70bn in monthly PEPP purchases since August**




Source: ECB, ING

**Fig 2 PEPP primarily of relevance to govies**




Source: ECB, ING

## Asset purchase programme: back to a monthly €20bn

Meanwhile, the net purchases under the asset purchase programme (APP) will continue at a monthly pace of €20bn, with the ECB committed to continue to buy assets under this programme for as long as necessary to reinforce the impact of its rates policy.

Purchases are not expected to end until shortly before the ECB starts lifting its key rates again. The same holds for reinvestments of redemptions under the programme. The ECB will continue to fully reinvest maturing securities under the programme, at least until

after the date the central bank starts raising its interest rates again, and for as long as necessary to maintain an ample degree of monetary accommodation.

> *"APP purchases will return to €20bn per month after the €120bn envelope ends"*

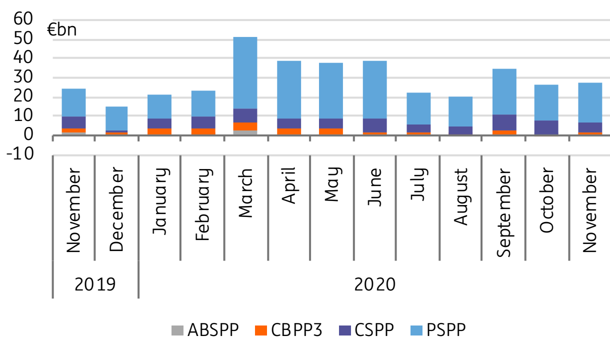
The €120bn envelope put in place after the coronavirus started, has not been extended and will end this year. We estimate that of the roughly €115bn bought in the period March until November this year on top of the monthly €20bn target under the APP, 94% has been allocated to the PSPP instead of to the private sector purchase programmes as initially intended.

The phasing out of the €120bn envelope by the end of this year, could indeed coincide with a bit of a step up in public sector purchases under the PEPP as of January. This would also explain the difference between the €72bn per month estimate resulting from the extension and expansion of the PEPP, versus the roughly €60bn to €70bn monthly buying range for the PEPP seen for the months August until November 2020.

Meanwhile, it is fair to say that of the private sector purchase programmes, the CBPP3 has probably benefited the least from the €120bn envelope. In comparison to the net monthly purchases seen in the four months from November 2019 until February 2020, it is clear that despite the €120bn envelope, the CBPP3 has even become a less active net buyer during the course of 2020.

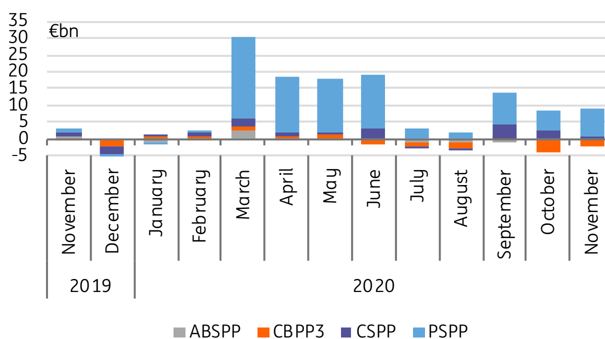
Irrespective of the €120bn envelope, net CBPP3 purchases have on aggregate even been €6bn lower from March to November 2020 than what could have been realised with a stable purchase pattern versus November 2019 to February 2020. In our view, this can mostly be explained by the relatively higher reinvestments of redemptions under the CBPP3 in the second half of the year (€19.8bn in 2H20 versus €12.4bn in 1H20).

**Fig 3 APP purchases will return to €20bn per month**




Source: ECB, ING

**Fig 4 The €120bn envelope had most impact on PSPP**




Source: ECB, ING

That said, we doubt we will see this slower net purchase trend change for the CBPP3 into 2021 considering (a) the subdued primary market prospects for covered bonds in light of today's additional TLTRO-III announcements, (b) the significant 43% share the ECB already holds of the Eurozone EUR benchmark covered bond market and (c) with the estimated reinvestments of redemptions by the CBPP3 still aggregating to €17.2bn in 1H21, albeit to a lower €12bn in 2H21.

> *"Public sector purchases of more relevance to the performance of covered bonds than CBPP3"*

For the performance of the covered bond market, we don't expect this to make that much of a difference. In the end covered bond spreads will reap more benefits from the performance support for governments bonds as a result of the ECB's buying activities in the public sector domain than from the central bank's direct purchases of Eurozone covered bonds. Also, the TLTRO-III

operations, in our view, will – if any – have a stronger positive performance impact on covered bonds than the CBPP3, (a) via their positive impact on (bank) demand in combination with (b) their negative impact on supply.

## ECB eases again TLTRO terms

The ECB provides banks three year funding via its third Targeted Longer-term Refinancing Operations (TLTRO-III). As of today, the operation size stands at €1,749bn. The ECB today announced that it will further recalibrate the terms of the TLTRO-III programme. Firstly, the special interest rate period is extended by 12 months to June 2022. Secondly, three additional tranches are to be added to the operation that will be conducted between June and December 2021. Thirdly, the total amount that banks can draw from the operations was increased from 50% of eligible loans to 55% of eligible loans. And lastly, in order to provide an incentive for banks to sustain the current level of bank lending, the recalibrated TLTRO-III borrowing conditions will be made available only to banks that achieve a new lending performance target. We take a look at each of these changes.

### 1. Longer special interest rate period

The ECB launched another special interest rate period running from 24 June 2021 until 23 June 2022 for all outstanding TLTRO-III operations. This basically extends the current special interest rate period of 24 June 2020 until 23 June 2021 by one year.

*"Banks can obtain TLTRO funds at -1% interest rate for two years if they meet their sets of lending benchmarks"*

During this second special interest rate period, the interest rate on all outstanding TLTRO-III tranches is set to 50bp below the average MRO rate over the same period. With no changes in the ECB reference rates, this would mean a -0.50% rate for TLTROs between June 2021 and June 2022 for all banks participating in the programme. Furthermore, for **banks that will reach the new lending performance threshold between 1 October 2020 and 31 December 2021**, the interest rate applied from 24 June 2021 until 23 June 2022 will be 50bp below the average deposit facility rate prevailing in the same time period, but in any case it will not be higher than -1%. Thus, with no reference rate changes, banks may benefit from a TLTRO rate as low as -1% between June 2021 and June 2022 if the bank met the lending benchmark, and otherwise enjoy a rate of -0.50% during this time period.

If the bank won't meet the new lending threshold, after the second special interest rate period the interest rate of the TLTRO tranches I-VII will be set as based on the previous terms. The rate is set at -0.50% if the bank exceeds benchmark net lending in the first special reference period (1 March 2020 until 31 March 2021) or exceeds the benchmark by at least 1.15% in the second reference period (1 April 2019 and 31 March 2021). The rate is set at between 0% and -0.50% if the bank exceeds the lending benchmark by less than 1.15% in the second reference period. Or lastly, the borrowing rate is set at 0%, if the bank doesn't meet any of the lending benchmarks. For the new three TLTRO tranches instead, if the bank doesn't meet the new lending benchmark threshold, the interest rate sets to the average prevailing MRO rate, currently at 0%, after the special interest rate period ends.

Lengthening the special interest rate period by 12 months until June 2022 means that banks can benefit from the most attractive lending rate for a longer time. With the previous terms, the special interest rate period was set to end in June 2021. If banks were not to meet either of their lending benchmarks, after the special interest rate period the TLTRO rate would have increased to 0%. For other banks the rate would have increased to -0.50% or varied between -0.50% and 0% depending on their lending development. The higher TLTRO rate would have created pressure for some banks to pay

back their funds early in September 2021. Lengthening the special interest rate period now takes the pressure off from banks to consider early repayments in the course of 2021 to a large degree in our view. We expect this to have a negative effect on bank bond supply in 2021. The longer special interest rate period should instead support bank net interest income development and especially so assuming the bank in question meets its lending thresholds.

The lengthening of the special interest rate period will have to be accompanied later on by a lengthening of the easing of the leverage ratio calculation to make it effective in our view. Banks can currently exclude central bank deposits from their leverage ratio calculation to allow for utilising the TLTRO operation fully.

### 2. Three new TLTRO tranches

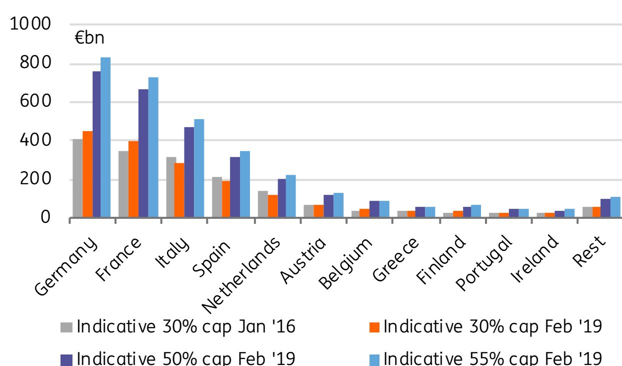
The decision of the ECB to offer three additional tranches of TLTRO-III means that banks will have access to liquidity at favourable terms at least until the end of 2024. Previously the TLTRO-III operation was set to include altogether seven tranches with the last tranche in March 2021. The new tranches will be added in June, September and December 2021. With a three-year maturity the TLTRO-III programme will provide liquidity to banks until the end of 2024. The new tranches will have early prepayment options on a quarterly basis starting from June 2022, nicely in line with the end of the new extended special interest rate period this time around. The new tranches will have a limiting impact on bank bond supply also going into 2022 in our view.

### 3. Higher amount of funds per bank made available

As many banks have utilised the TLTRO-III operation already close to their maximum capacity, the only way to further push up the size of the programme and guarantee interest for the future tranches for the ECB is to lift the available funds per bank. The ECB increased the total amount that banks can draw from the TLTRO-III operations from 50% of eligible loans to 55% of eligible loans as of 28 February 2019. Eligible loans include lending to households and corporates excluding mortgages. This should support the demand in the upcoming TLTRO-III tranches in our view.

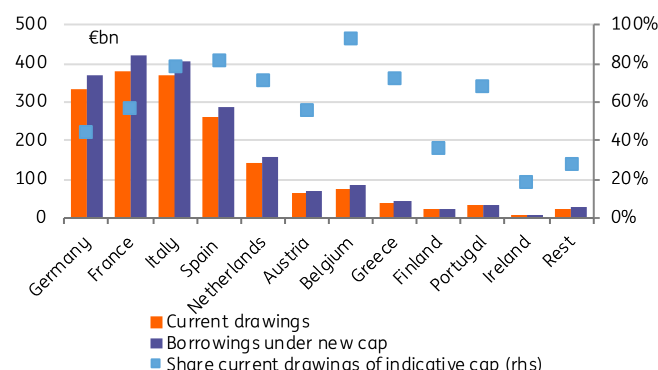
We consider the increase of the TLTRO cap to result in a €290bn increase in TLTRO-III borrowing capacity (Figures 5 and 6). That said, not all Eurozone lenders are likely to participate. Using a similar percentage of drawings versus maximum capacity as previously would point towards a further headroom of €175bn in TLTRO-III drawings. This is excluding the effect of the TLTRO-III.6. The higher TLTRO-III capacity should support availability for further drawings from French, Italian, German and Spanish banks.

**Fig 5 Bank lending capacity per country**




Source: ECB, ING

**Fig 6 Indicative room for further TLTRO-III drawings**




Source: ECB, ING

### 4. New lending performance target

Introducing new TLTRO-III tranches had to come with a new and longer lending reference period in our view as the current reference periods run until March 2021 that is

only one quarter away. According to the ECB, to provide an incentive for banks to sustain the current level of bank lending, the recalibrated conditions will be made available only to banks that achieve a new lending performance target.

*"New 0% lending target between October 2020 and December 2021"*

The ECB indicates that to benefit from the new second special interest rate period running from June 2021 until June 2022, the eligible net lending of a bank would need to reach between 1 October 2020 and 31 December 2021 the lending performance threshold that is set at 0%. While the level is similar to what is in place for the first special reference period, we consider that for banks it may be more difficult to reach the new lending target than the previous one. While the substantial government measures in place have supported lending development this year, this effect may not carry into 2021 in a similar magnitude.

Previously, the TLTRO-III programme had already two performance targets. The first special interest rate setting was tied to reaching the lending threshold during the first special reference period running from 1 March 2020 until 31 March 2021. On top of this, the second lending benchmark period was set to run from 1 April 2019 until 31 March 2021.

## Four new PELTRO tranches

The ECB indicated to offer four new tranches of pandemic emergency longer-term refinancing operations (PELTROs) in 2021 on a quarterly basis. Each tranche has a maturity of one year and the pricing is fixed at 25bp below the average MRO rate (currently 0%). PELTROs provide an additional source of longer-term funding for banks.

The programme is mainly targeted to banks with business models that focus on lending to sectors that are not covered by the TLTRO-III programme in our view. The PELTRO programme was based on seven separate tranches with the last tranche prior to the new additions already allocated earlier this December.

## Collateral easing measures extended

The ECB also decided to extend the duration of the collateral easing measures adopted in April this year until June 2022, to ensure that banks can continue to make full use of the (recalibrated) TLTRO operations. This matches the extended June 2022 expiration date for the favourable TLTRO-III terms. We note that the collateral easing measures were initially intended to last until September 2021, the month that the first early repayment opportunity under the TLTRO-III operations was due. The ECB will now reassess the collateral easing measures again before June 2022 to make sure that the participation by Eurozone banks in the TLTRO-III operations is not adversely affected.

*"Eased collateral rules extended until June 2022 to support TLTRO-III use"*

The emergency collateral package announced in April 2020 provided among others for an increase of the use of credit claims as collateral, via an expansion of the additional credit claims (ACC) framework for NCBs. The requirements on guarantees were for example eased to provide liquidity against government and public sector guaranteed loans to corporates granted in light of the Covid-19 crisis. Besides, the €25,000 non-uniform minimum size threshold for domestic credit claims was removed to facilitate collateral acceptance of loans to small corporates, while the usage limit for unsecured debt instruments from a single other bank was increased from 2.5% to 10%.

The ECB also at that time adopted a minimum credit quality waiver for the collateral acceptance of Greek government bonds. Another temporary measure involved the alleviation of the risk tolerance level in the central bank's credit operations via a

reduction of the collateral valuation haircuts by 20%. Later on in April, the ECB also decided to temporarily cushion the impact on collateral availability from rating downgrades as a consequence of the Covid-19 crisis, by still accepting eligible marketable assets that lost their IG rating after 7 April (up to a first best rating of BB).

## What we didn't get: change in tiering

The ECB supported the banking sector by providing banks with access to liquidity at favourable conditions via their funding operations. What they did not do, was to provide additional aid in terms of absorbing the impact of negative interest rates by increasing the tiering multiplier. Banks can deposit an amount that corresponds to six times their minimum reserve requirements at 0% to the central bank. Above this threshold the deposit rate of -0.50% kicks in. Increasing the tiring multiplier to above 6 would have increased the amount banks can deposit at no cost at the central bank.

## Decision on bank dividends next week

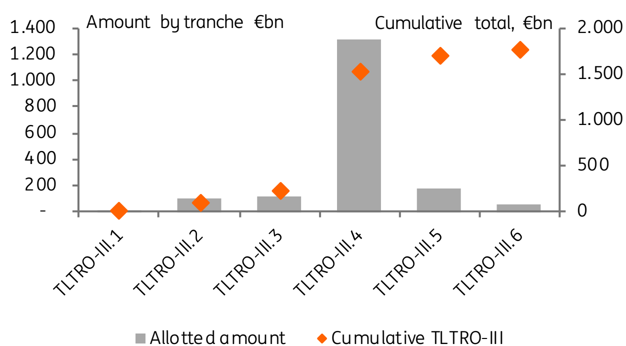
The ECB did not discuss bank dividends in the meeting today. Earlier today, the ECB's supervisory board was said to decide on whether and how to lift the bank dividend ban at a meeting next week, according to Bloomberg. European watchdogs are leaning towards extending the ban well into next year, while allowing some lenders to make payouts if they can show sufficient financial strength, according to people familiar with the matter as cited by Bloomberg. Based on these comments, it seems unlikely that banks will be able to return to normal in terms of dividend payments early next year.

The ECB gave a recommendation in March for banks not to distribute dividends due to the substantial uncertainty regarding Covid-19 and its possible effects on bank loan quality from financial years 2019 and 2020. The ban was set at least until 1 October 2020. In July this year the ECB extended its recommendation on not to pay dividends until January 2021.

## TLTRO-III 6th tranche small as expected

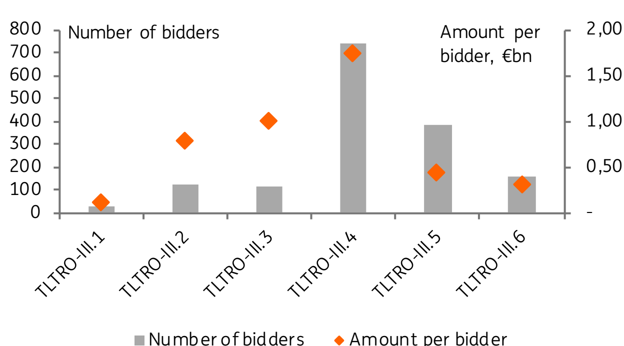
Before the ECB meeting, the ECB indicated today that banks drew €50.4bn from the 6th tranche of the TLTRO-III operation. The number compares with €174bn in tranche five, and €1,308bn in tranche four (Figure 7). After the 6th tranche the TLTRO-III operation currently amounts to €1,749bn in total spread across six different tranches.

**Fig 7 TLTRO amounts per tranche**




Source: ECB, ING

**Fig 8 Average TLTRO drawings per bank**




Source: ECB, ING

Altogether 156 banks participated in the tranche six, implying that the average drawing was only €0.32bn per bank (Figure 8). This likely reflects the smaller nature of the participating banks in our view. We consider that many larger banks have already drawn close to their full allowance from TLTRO-III. As a comparison, in June 388 banks drew funds from the 5th tranche resulting in an average drawing of €0.45bn. The highest

number of participating banks so far was not surprisingly in the 4th tranche with 742 bidders and an average drawing of €1.76bn per bank.

All TLTRO tranches allow for benefiting from the special interest rate period running from June 2020 until June 2021. Participating in the 4th tranche provided however the maximum possible benefit of the favourable special interest rate period, the likely reason for the large participation. Please see what we wrote about tranche 5 here.

The TLTRO interest rate is tied to bank lending development. See our piece What weak bank lending and strong deposit inflows mean for the ECB for further insights into lending development in the Eurozone.

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