25 September 2020
Financials

European banks

Do they have what it takes?

European banks have so far drawn €1,699bn funding from the ECB TLTRO-III operations. We examine whether banks are likely to reach the lending thresholds that would allow them to benefit from the lowest available funding rates.

European banks drew €174.5bn from the fifth tranche of the ECB funding programme TLTRO-III yesterday, substantially down from the €1,308bn drawn from the fourth tranche. The total size of the TLTRO-III programme stands at a substantial €1,699bn. Motivation to participate in the fifth tranche could have been driven by growing understanding of bank loan demand in the Covid-19 environment, a possible access to funds at the -1% level until June 2021, the consideration of no stigma or reputational risk left after the significant June take-up, and a removal of a possible leverage ratio constraint.

The interest rate in the ECB TLTRO-III operation is tied to lending development. If banks meet the set lending criteria, they can obtain the TLTRO funding at a rate as low as -1% for one year and at -0.50% for the rest of the time. In our view, banks are in general well positioned to meet the benchmark with their eligible net lending growth on a country basis by March 2021. Yet there are clear country differences. Countries where initial liquidity needs were mostly met by bank loans and, in turn, backed by government guarantees, are comfortably above the benchmark. This applies to Spain, Italy, Portugal, but also France. At the other end of the spectrum are countries where more of the support was provided by governments directly to businesses and households, mainly via tax deferrals and temporary wage support schemes. This is the case in, for example, Germany and the Netherlands. Despite the fact that the latter group of countries has less leeway above the benchmark, we think all countries presented here are in a good position to meet or exceed the net lending benchmark. Countries are also generally on track to meet or exceed the benchmark in the second reference period.

French and Italian banks were the largest users of the ECB's longer-term refinancing operations in July, drawing €350bn and €345bn, respectively, followed by German and Spanish banks, at €284bn and €257bn, respectively. This is not surprising taking into account the lending developments and the bond market pricing. The banking sectors of France, Spain and Italy are among those showing the strongest lending growth in the special reference period. Among them, Italy and Spain in particular, but also to a lesser extent France, stand to benefit from the attractive funding levels of the TLTRO programme as compared to funding via bond markets.

From a funding cost angle, it would currently make sense for banks across the Eurozone to draw funds from the TLTRO-III, especially if they were to meet the special reference period lending benchmark and thus realise the attractive -1% rate for one year and a rate of -0.5% for the rest of the operation. The TLTRO-III tranches I-V have the first repayment opportunity in September 2021. Thus, banks can enjoy the special interest rate period, and only then consider whether to repay the funds early or keep them to maturity. The willingness to repay early is likely to be driven by lending development, bond market trading levels, tiering effects and the economic outlook.

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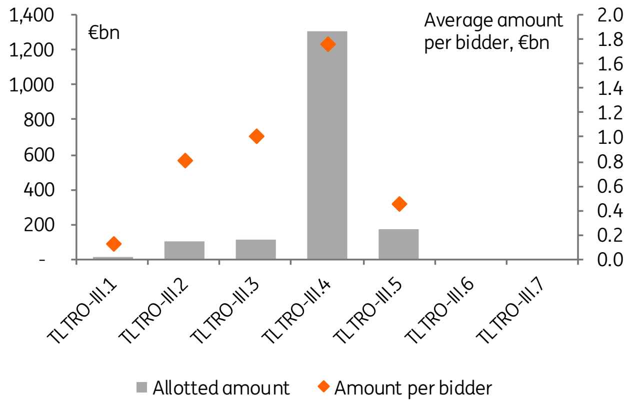
Banks draw €174.5bn funds from the fifth tranche of the TLTRO-III

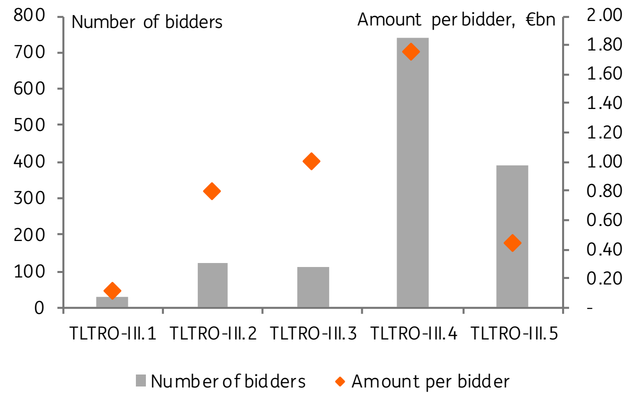
European banks drew €174.5bn from the fifth tranche of the ECB funding programme TLTRO-III (Figure 1). Adjusting for the repayment of €11bn, the net addition of excess liquidity was €163bn. The c.€175bn figure is substantially smaller than the €1,308bn drawn from the fourth tranche. After the fifth tranche the total size of the TLTRO-III funding programme now stands at a substantial €1,699bn. The smaller allotted amount compared with the previous tranche should not come as a surprise to the market with expectations ranging between €10bn and €200bn, even though we could have imagined the figure to be even smaller than it was.

Fig 1 TLTRO-III drawings



Source: ING, ECB

Fig 2 Number of bidders for TLTRO-III programme



Source: ING, ECB

The motivation to participate in the fifth tranche could have been, among others, driven by a better visibility into the lending developments in the Covid-19 environment. The fifth tranche still allows banks to benefit from the special interest rate period until June 2021, subject to meeting the lending benchmark. This, of course, assumes the bank in question has further room in its TLTRO borrowing allowance.

Based on the number of bidders, it looks like smaller banks, in particular, drew funds from the fifth tranche. Altogether 388 bidders participated, compared with 742 bidders for the fourth tranche (Figure 2). The average drawing per bank was €0.45bn in the fifth tranche, the smallest since the first (tiny) tranche of €3bn when the average drawing was €0.12bn. As a comparison, the average allotment per bidder was €1.76bn in the fourth tranche in June. Smaller average bids could point to smaller banks being more comfortable in bidding after the fourth tranche. If there was any concern left of possible reputation risk or stigma, the significant take up in June has erased it.

TLTRO-III funding programme consists of seven tranches with two more tranches remaining for settlement in 16 December 2020 and 24 March 2021 (Figure 3). All tranches have a three-year maturity with tranche five the last to have a first repayment option set at 29 September 2021. Tranche seven offers a maturity date extending to March 2024, which is likely to be a supporting factor for its demand.

Fig 3 The TLTRO-III schedule

	TLTRO-III.1	TLTRO-III.2	TLTRO-III.3	TLTRO-III.4	TLTRO-III.5	TLTRO-III.6	TLTRO-III.7
Settlement date	25.9.2019	18.12.2019	25.3.2020	24.6.2020	30.9.2020	16.12.2020	24.3.2021
Early repayment settlement date	29.9.2021	29.9.2021	29.9.2021	29.9.2021	29.9.2021	22.12.2021	30.3.2022
Maturity date	28.9.2022	21.12.2022	29.3.2023	28.6.2023	27.9.2023	20.12.2023	27.3.2024

Source: ING, ECB

The logic behind the TLTRO-III interest rate setting

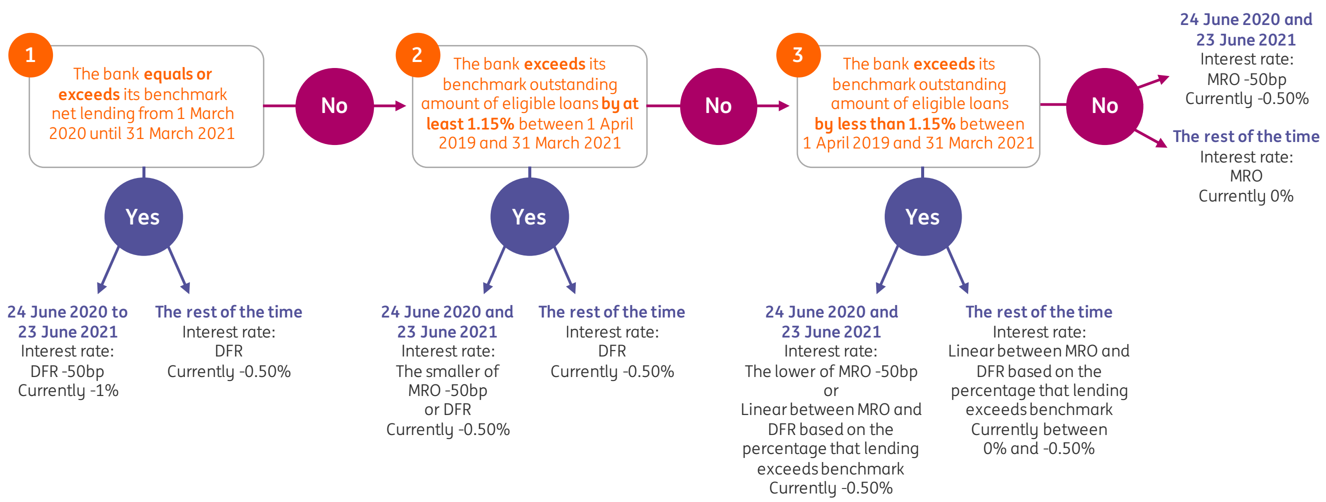
The interest rate in the ECB TLTRO-III operation is tied to a bank's lending development. Simply put, there are two reference periods used to assess loan growth: the special reference period that runs from 1 March 2020 until 31 March 2021 and the second reference period from 1 April 2019 and 31 March 2021.

'Eligible net lending' (lending to businesses plus non-mortgage lending to households) in the special reference period should exceed zero, but if benchmark net lending in April 2018 to March 2019 was negative, the net lending should at least exceed this benchmark. In the second reference period, the performance is instead assessed against the outstanding amount of eligible loans at the end of March 2019, with an adjustment for benchmark net lending if that is negative.

The three reference points to look for

We summarise the three reference points to look for to get a picture of the expected interest rate of the TLTRO operation in Figure 4. The TLTRO interest rate is set separately for the special interest rate period from 24 June 2020 until 23 June 2021 and for the rest of the operation. Banks that meet the first criterion (ie, banks that meet or exceed the benchmark net lending between 1 March 2020 to 31 March 2021) can realise TLTRO lending rates of -1% for the special interest rate period and -0.50% for the rest of the operation based on current reference rates. Banks that reach the second set of criteria (ie, banks that don't meet the benchmark net lending in the special reference period between 1 March 2020 to 31 March 2021, but do exceed by at least 1.15% the benchmark outstanding amount of eligible loans during the second reference period of 1 April 2019 and 31 March 2021), can realise a TLTRO rate of -0.50% with current reference rates for the full length of the operation. Banks that reach the third set of criteria (ie, the bank does not meet its benchmark net lending in the special reference period, and exceeds its benchmark outstanding amount of eligible loans during the second reference period by less than 1.15%), can realise a lending rate of -0.50% for the special interest rate period and, for the rest of the time, a rate that varies between 0% and -0.50% depending on the lending development. Lastly, banks that do not meet any of the lending criteria can realise an interest rate of -0.50% for the special interest rate period and 0% for the rest of the operation with current reference rates.

Fig 4 TLTRO-III interest rate setting criteria: The three reference points



Source: ING

Beating the lending benchmark

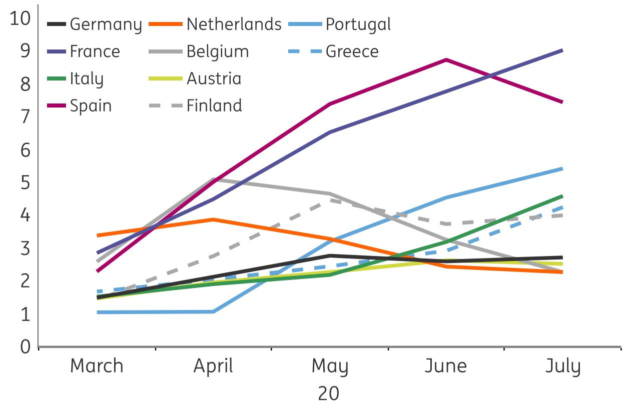
The special reference period

So how is bank lending developing? We first look at the "special reference period". In this period, the hurdle of eligible net lending is zero for most banks, but for banks with negative benchmark net lending in the first reference period, the hurdle is this negative benchmark. We calculate lending performance against the benchmark on a country basis using the ECB's monthly banking statistics. We would be the first to point out that this conveys limited information only: individual bank lending growth may deviate from countrywide growth for various reasons, even if the bank is active mainly or only in that country. Yet the country benchmarking exercise does convey some information regarding where a bank stands in achieving the benchmark.

Figure 5 shows eligible net lending growth per country compared to the country net lending benchmark. As can be seen from the chart, after the initial bank lending surge in March to May 2020, net lending decelerated and even turned negative in the summer in some countries. Yet all countries remain well positioned to make the benchmark (in the chart, that means ending above zero by March 2021). Still, there are clear country differences. Countries where initial liquidity needs were mostly met by bank loans (that were in turn backed by government guarantees), instead of tax deferrals and temporary wage support schemes, are, understandably, comfortably above the benchmark. This applies to Spain, Italy, Portugal, but also France.

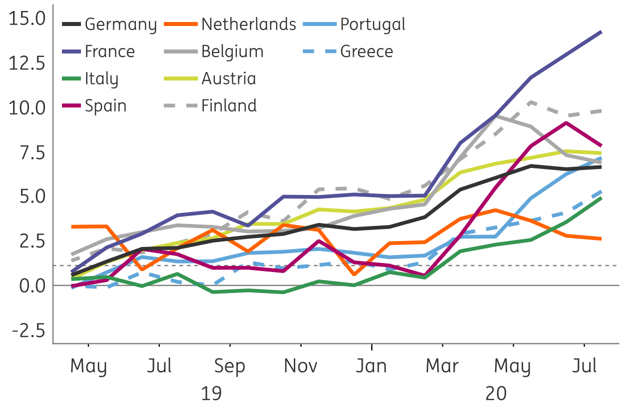
At the other end of the spectrum are those countries where more of the support was provided by governments directly to businesses and households, rather than indirectly by loan guarantee schemes. This is the case in, for example, Germany, the Netherlands and Belgium. Our earlier publication Eurozone business borrowing in Covid-19 times provides an explanation of the differences in demand for bank loans across countries.

Fig 5 Cumulative eligible net lending since March 2020 (%)



Lending to businesses and non-mortgage lending to households. Compared to country net lending benchmark as defined by ECB. Corrected for sale/securitisation where applicable.
Source: ING-calculations based on ECB-data.

Fig 6 Cumulative eligible net lending since April 2019 (%)



Lending to businesses and non-mortgage lending to households. Compared to country net lending benchmark as defined by ECB. Dotted line shows 1.15% threshold. Corrected for sale/securitisation where applicable.
Source: ING-calculations based on ECB-data.

Despite the fact that the latter group of countries is closer to the benchmark, and some are trending down towards it, we do think that meeting or exceeding the net lending benchmark remains within reach for all countries. In countries where businesses initially relied on direct government liquidity, that liquidity support will slowly be scaled backed in the coming quarters. As that happens, some otherwise healthy businesses will have to turn to their banks for liquidity. While we shy away from attempting to quantify any effect of fading government liquidity support on bank loan demand, it will likely have some upward effect, materialising in the last months of the special reference period – assuming current plans to start scaling back government support are not reversed in the face of a second winter lockdown, of course.

The second reference period

So most countries have a decent chance of making the special reference period benchmark. But countries are not banks. Should a bank fail to meet the benchmark in the special reference period, then the fallback in TLTRO interest rate terms is the 'second reference period'. Figure 6 shows performance on the benchmark for the second reference period, which is calculated in a slightly different way, but with the same correction of the net lending benchmark (NLB) in case it's negative. The benchmark to be met in this period is 1.15% (the dotted line in the chart). Again, most countries are still on track to meet or exceed the benchmark, with generally speaking a somewhat bigger margin than in the case of the special reference period.

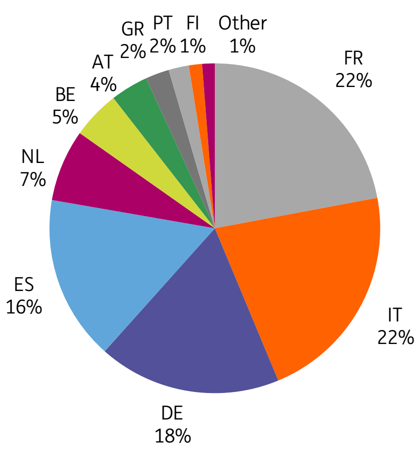
TLTRO vs bond markets: a look at current pricing

From a funding cost angle and based on the current pricing of both covered bonds and preferred senior unsecured debt, it would currently make sense for most banks across the Eurozone (on a country level) to draw funds from the TLTRO-III, especially if they were to meet the special reference period lending benchmark and thus realise the -1% rate for one year and -0.5% level for the rest of the life of the operation. None of the banking sectors are even close to the -1% yield level in the 2023 maturity bucket or even with 2021 bond yields due to the relatively flat curves.

We consider covered bonds and preferred senior unsecured debt to be the most natural funding alternative for banks as compared to the ECB TLTRO funding. While both covered bonds and TLTRO funding operations are secured funding options, preferred senior unsecured bonds are instead the likely logical funding alternative on the unsecured side. Banks are unlikely to print non-preferred senior unsecured or regulatory capital instruments purely for funding purposes simply because of the higher spread levels, in our view. Instead, the driving force behind the supply in these loss-absorbing bond segments is likely either MREL, or then Pillar 1 and Pillar 2 capital requirement related.

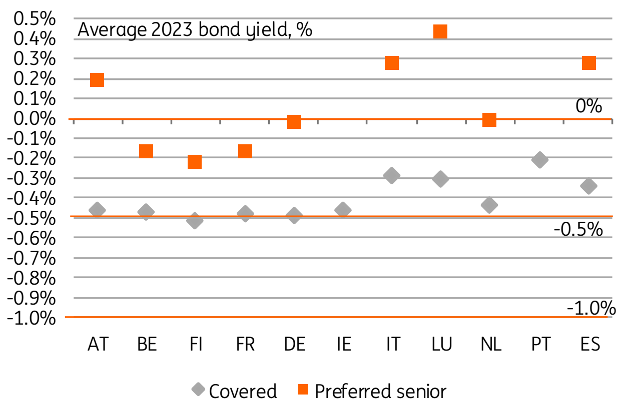
The current covered bond trading levels (Figure 8) in the 2023 maturity bucket are close to a -0.50% yield level in most Eurozone countries. Only banks in Italy, Luxembourg, Portugal and Spain currently see their yield levels at higher levels than this, positioned closer to -0.3% for most. The preferred senior unsecured debt yield levels are naturally higher than those of covered bonds as the spreads are pricing in a higher risk from the unsecured nature of the bonds. The Finnish, Belgian and French banks have the lowest average preferred senior yield levels positioned clearly at below the 0% level but above the -0.50% level. German and Dutch yields are close to 0% for 2023 maturities. Austrian, Italian, Spanish and Luxembourg banks' preferred senior debt is quoted with a yield of between 0.20% and 0.40% in the 2023 maturity bucket.

Fig 7 Longer-term refinancing operations, end-July 2020



Source: ING, ECB

Fig 8 Covered and preferred senior bond yields (%)*



*2023 averages except for Portugal 2022
Source: ING

Based on covered bond trading levels, banks in Austria, Belgium, Finland, France, Germany, Ireland and the Netherlands would benefit from the TLTRO especially if they were to meet the criteria for the special reference period to realise the -1% interest rate. Banks in Italy, Luxembourg, Portugal and Spain may benefit from the TLTRO funding advantage even with a lending development beating the second reference period benchmark by less than 1.15%. As an example, beating the lending benchmark by 0.7% would result in a TLTRO rate of -0.5% for the special interest rate period and -0.3% for outside the special interest rate period, with the latter relatively close to the covered bond trading levels in these areas.

If banks were not to reach any of the lending criteria, the TLTRO funding could be obtained at -0.5% for the special interest rate period and at 0% for the rest of the time. This could look attractive for banks as an alternative to printing a preferred senior unsecured bond, especially in countries with more elevated preferred senior trading levels, such as in Luxembourg, Italy, Spain and Austria.

The large TLTRO-III drawings will likely remain a muting factor for bank bond supply for now with the effect likely to be felt especially by pure funding instruments, including covered bonds and also preferred senior unsecured debt.

French and Italian banks likely to remain the largest TLTRO-III users

Looking at the lending developments and also the current market pricing, it is perhaps not surprising that French and Italian banks have been the largest users of the ECB longer-term refinancing operations with €350bn and €345bn of drawings, respectively, as of end-July 2020 (Figure 7). They were, at the time, followed by German and Spanish banks with €284bn and €257bn, respectively. Benelux banks had drawn €194bn from the ECB LTROs with the Netherlands at €112bn and Belgium at €75bn as of end-July.

The data includes the effect of the TLTRO-III.4, but not the impact of the fifth tranche. The country-based data including the fifth tranche will be available on 7 November. In our view the country split is likely to remain relatively similar also after the fifth tranche with the relatively limited TLTRO-III.5 drawings compared to the TLTRO-III.4 drawings.

As noted above, the banking sectors in Spain, Italy, Portugal, and France have shown the strongest lending growth in the special reference period. Among these, especially Portugal, Italy and Spain, but also to a lesser extent France, stand to benefit from the attractive funding levels of the TLTRO programme versus bond markets pricing.

Tiering and leverage ratio calculation supportive

Other factors outside the lending development and bond pricing that may have an impact on the bank TLTRO usage include, among others, the tiering of central bank deposits and the recent changes in the leverage ratio calculation. Banks can currently deposit six times their minimum reserve requirement at zero to the central bank (instead of at the current -0.50% deposit facility rate). Thus, utilising TLTRO funding could be even more attractive for banks that see loan growth and that have room in their zero % bucket in the central bank.

Last week, the ECB announced that euro area banks under its direct supervision may apply relief measures in the calculation of the leverage ratio. The Governing Council has determined that exceptional circumstances exist that warrant the exclusion of the central bank exposures from the total exposure measure in order to facilitate the implementation of monetary policies. Banks are allowed to exclude central bank exposures that are deemed relevant for the transmission of the monetary policy, such as deposits held in the deposit facility and balances held on reserve accounts with the Eurosystem, including funds for the minimum reserve requirements.

In the Eurosystem, the largest deposit facility and current account balances are in Germany, France, the Netherlands, Spain and Italy. The highest shares of central bank deposits relative to the aggregated total bank assets are in Finland, Belgium and Luxembourg. Ireland, Italy and Greece are among the countries with a relatively smaller share of central bank deposits vs assets. The average leverage ratios for bond issuers are lower in the Netherlands, France and Belgium and higher in Greece, Ireland and Finland.

Repayment activity to be driven by lending and rates development

The five TLTRO-III tranches that have been allotted so far, have the first repayment opportunity in September 2021, after the end of the special interest rate period in June 2021. Thus, banks can enjoy the special interest rate period, and only then consider whether they want to repay the funds early or keep them to maturity.

The willingness to repay early is likely driven by, among others, the following factors:

- **lending development:** is the TLTRO funding still needed and what interest rate is applied to TLTRO funding after the special interest rate period ends,
- **secondary bond trading levels:** is it cheaper to refinance via bond markets or stick to the TLTRO funding,
- **tiering effects:** does the maths of drawing at -0.50% and depositing at zero work,
- **economic outlook:** the level of uncertainty has probably the largest effect here, in terms of outlook for lending and loan quality.

Therefore, banks that continue to show strong enough loan growth and that can realise a TLTRO lending rate of -0.50% even after the special interest rate period ends are most likely to stick with the funds. These banks could be in countries showing the strongest lending growth as mentioned above. We would not rule out a further easing of the TLTRO-III terms, if the pressure on the economy from the Covid-19 pandemic takes a turn for the worse with substantial impact on lending prospects and bank loan quality. Any further easing of the terms would naturally limit repayment activity.

For banks that do not meet benchmark lending targets, it would be difficult to further benefit from the TLTRO-III given the pricing. Not meeting the lending targets would mean that the TLTRO rate would reset to 0% after the special interest rate period. These are mainly smaller issuers with some of them having company-specific problems. That said, in our view, most banks have access to bond market financing at below 0% yield levels in the current market environment. Thus, banks that would not be able to meet the lending criteria, would be more likely to pay back the funds early and refinance via bond markets.

Conclusion

Based on recent lending developments in the Euro area, for most banks, meeting the lending benchmark that is required to qualify for the lowest TLTRO rates, remains within reach, in our view. This has already been reflected in the large take-up so far in the operation, which currently totals €1,699bn.

In addition to the adequate lending growth, the tiering mechanism and leverage ratio relief measures have likely removed a disincentive for banks to attract large TLTRO sums. The leverage ratio impact of depositing any excess back with the ECB has become less penalising. This could have particularly supported fresh TLTRO demand in the most recent operation from banks with leverage ratio constraints.

The September 2021 repayment option will be a welcome opportunity for banks to take stock of their funding needs, TLTRO rates and bond market pricing levels, loan portfolio growth and the general state of the economy. Especially any banks that struggle to meet the lending benchmarks, could look into paying the funds back early in September 2021.

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