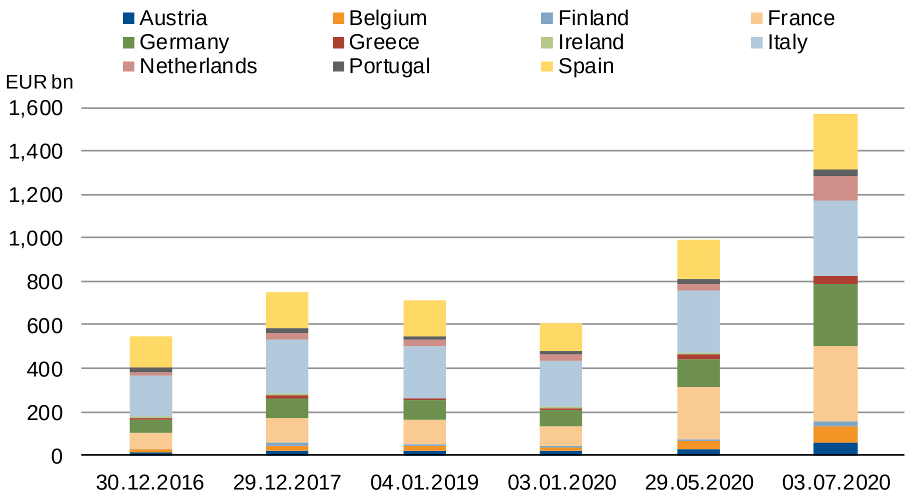
# TLTRO III: what the ECB's EUR 1.3trn cash injection means for euro area banks

**The European Central Bank has largely neutralised liquidity risk for euro area banks as a side effect of its targeted longer-term refinancing operations (TLTRO III). With the easing of eligibility conditions and attractive pricing, outstanding LTROs rose by 30% to EUR 1.6trn in June. That's equivalent to 4.6% of the consolidated banking assets of the euro area (EUR 35trn). Scope views the easing of refinancing conditions through this liquidity support mechanism as credit positive. The next allotment will take place at the end of September.**

There are three principal ways to look at TLTRO III and what it means for banks:

- The primary goal of LTROs is to facilitate the transmission of monetary policy to the real economy by providing attractive refinancing conditions to banks. In turn, banks are supposed to provide attractive lending conditions to the private sector. The ECB monitors the functioning and success of this policy tool through interest rates and lending growth parameters. Just two months after the marked TLTRO III push, it is too early to reach any conclusions.
- TLTRO III is unprecedented not only because of its size – the outstanding amount is still only about half of the ECB's firepower – but also because of its pricing, as it can neutralise some of the effects that negative rates have on banks' P&Ls. If banks meet customer lending conditions, the ECB will give back several billion to borrowing banks. Its impact on banks' net interest margins, interest revenues and net incomes is under market scrutiny.
- Recourse to the temporary but gradually increasing and repeatedly rolled-over LTROs has gained new status with the last take-up as an alternative refinancing tool for banks. The much broader geographical mix and size of the last take-up shows that market perceptions of recourse to ECB refinancing have changed dramatically. While the ECB acts as lender of last resort for banks, the TLTRO programme has also made it lender of first resort. Several large banks have borrowed between EUR 50 bn and EUR 100 bn in one go, which implies high single-name concentration on the liabilities side. Many banks have adjusted downward their wholesale funding plans for the rest of the year, while short-term placement strategies of excess liquidity have also markedly benefited European banks' liquidity profiles.

**Figure 1: How TLTRO III is changing recourse to ECB's LTROs**




TLTRO: Targeted Longer-Term Refinancing Operations. Source: ECB, Scope Ratings

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## What's behind the massive TLTRO III June pick up

A total of 742 bidders participated in the TLTRO III.4 allotment on June 24 for EUR 1.3trn. Given partial repayment of TLTRO II borrowing, it brought the total outstanding amount of LTROs close to EUR 1.6trn. The next allotment is due at the end of September. The spare capacity is broadly equivalent to the existing outstanding amount i.e. close to EUR 3trn in total, capped by the 50% limit on eligible lending (loans to corporates and households, excluding loans for housing).

We expect a catch-up effect from late participants and a roll-over of TLTRO II exposure, although take-up should be more modest. The most favourable period to participate was June 2020 to June 2021, and some banks are already at their maximum drawdown limits. Other will likely keep spare capacity intact, either for later use if needed, or to show that they can do without it.

From a rating perspective, this massive liquidity support is credit positive. It partly offsets other pressures on ratings from the Covid19 recession, specifically asset quality. The main challenge for participating banks will be to continue to manage funding and liquidity at arm's length, assuming no TLTRO IV. This exit strategy issue is a medium to long-term challenge, given the three-year maturity feature. This is also true for many of the other support measures put in place under the current challenging operating conditions.

Attractive pricing (whatever individual banks' net lending performance); optional early repayment after the most favourable borrowing window; and evaporating stigma for banks relying on central bank funding are all strong incentives for banks to participate. However, controlling balance-sheet growth while maintaining sound capital adequacy, especially leverage ratio management, could limit banks' appetite.

**Table 1: The ECB indicative TLTRO calendar and allotted amounts**

| TLTRO I & II Series | Settlement date* | Maturity date* | Allotment EUR bn |
|---|---|---|---|
| I.1 | 24/09/2014 | 26/09/2018 | |
| … | | | |
| I.8 | 29/06/2016 | 26/09/2018 | |
| II.1 | 29/06/2016 | 24/06/2020 | 399.3 |
| II.2 | 28/09/2016 | 30/09/2020 | 45.27 |
| II.3 | 21/12/2016 | 16/12/2020 | 62.16 |
| II.4 | 29/03/2017 | 24/03/2021 | 233.47 |

| TLTRO III Series | Settlement date* | Maturity date* | Allotment EUR bn |
|---|---|---|---|
| III.1 | 25/09/2019 | 28/09/2022 | 3.4 |
| III.2 | 18/12/2019 | 21/12/2022 | 97.7 |
| III.3 | 25/03/2020 | 29/03/2023 | 115.0 |
| III.4 | 24/06/2020 | 28/06/2023 | 1,308.4 |
| III.5* | 30/09/2020 | 27/09/2023 | - |
| III.6* | 16/12/2020 | 20/12/2023 | - |
| III.7* | 24/03/2021 | 27/03/2024 | - |

ECB initial calendar is subject to revisions. Source: ECB, Scope Ratings.

The attractions of the TLTRO III.4 drawdown lie in the relaxation of TLTRO III terms and conditions. Given the exceptional circumstances related to Covid-19 and its potential impact on credit and funding, the ECB amended the key conditions in March and April 2020 (initially specified in March, June and September 2019). The revision of TLTRO III conditions should also be seen in the context of a broader set of supportive open market operations launched by the ECB since the beginning of the year.

**Table 2: Overview of ECB open market operations and related decisions**

| Calendar of selected actions 2020-2021 | | |
|---|---|---|
| **Date** | **Designation** | **Actions** |
| **24/03/2021** | **TLTRO** | **Settlement of the TLTRO III.7 allotment** |
| **16/12/2020** | **TLTRO** | **Settlement of the TLTRO III.6 allotment** |
| **30/09/2020** | **TLTRO** | **Settlement of the TLTRO III.5 allotment** |
| 30/04/2020 | PELTRO | Decision to launch a **Pandemic Emergency Longer-Term Refinancing Operations** series (seven operations, with decreasing tenor from 16 months to eight months.). The interest rate will be 25bp below the average MRO rate (currently 0%) over the life of the respective PELTRO. |
| 30/04/2020 | TLTRO | Amendment of TLTRO III framework (new lending criterion and revision of interest rates applied). |
| 07/04/2020 | Collateral | **Temporary collateral easing measures**: extending the scope of acceptance of credit claims, reducing valuation haircuts and grandfathering assets falling below credit-quality requirements |
| 18/03/2020 | PEPP | Decision to launch EUR 750bn **Pandemic Emergency Purchase Programme** running until end 2020. |
| 12/03/2020 | APP | Decision to add to the running **Asset Purchase Programme** (EUR 20bn monthly since Nov. 2019) an additional EUR 120bn net asset purchases until year-end. |
| 12/03/2020 | LTRO | Launch of bridge **Longer-Term Refinancing Operations** to facilitate transition between TLTRO II and TLTRO III series. |
| 12/03/2020 | TLTRO | Amendment of TLTRO III framework (revision of the borrowing allowance, bid limits and performance threshold. |

Source: ECB, Scope Ratings

**Attractive pricing was an obvious incentive**

We consider attractive pricing conditions were the main driver of this record tack-up. After tiering, which exempted a share of banks' excess liquidity from negative rates and provided some relief on margins, the ECB provided three-year funding at very appealing rates. Key characteristics of TLTRO III.4 included:

- The borrowing allowance was raised to 50% of eligible loans from 30%.
- The limit of 10% of the stock of eligible loans for funds that can be borrowed in each operation was removed.
- An early repayment option one year after settlement, starting in September 2021, providing more flexibility for banks to opt out.

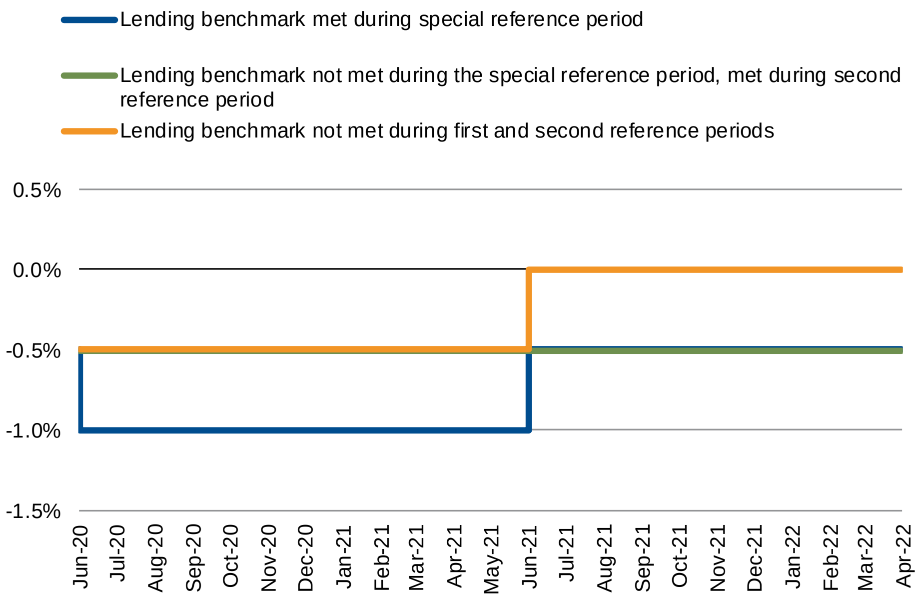
Figure 2 below provides an overview of pricing conditions according to the level of net lending to the real economy.

- For banks meeting the benchmark net lending requirement (set at 0%) during a special reference period (1 March 2020 to 31 March 2021), the interest rate applied between June 24 2020 and June 23 2021 is the average interest on the deposit facility over that period less 50bp, with a cap at -100bp. During the remaining period, the interest rate will be the average interest rate on the deposit facility of the life of the respective TLTRO III. Given the current deposit facility rate level, the rate is as low as -100bp between June 2020 and June 2021, and -50bp in the remaining period. For a bank taking up EUR 1bn in June, this would translate in a EUR 10m return to June 2021 and EUR 5m annually over the remaining life.
- For banks not meeting benchmark net lending, a 1.15% benchmark evaluated over a longer period of 1 April 2019 and 31 March 2021 will apply. For banks that meet this benchmark, the interest rate will be the MRO rate less 50bp during the special interest period and between the MRO rate over the life of the respective TLTRO III and the

deposit facility rate (DFR), depending on the deviation from the benchmark (for simplicity in Figure 2 we assumed it equal to the DFR rate). For a bank taking up EUR 1bn, the return would be equal to EUR 5m in the first year and between EUR 2.2m and EUR 5m annually for the remaining life.

- For banks not meeting the benchmarks in either period, the interest rate during the special period will be the MRO rate (-50bp) and during the remaining period the MRO rate. For a bank taking up EUR 1bn, the return for the first year would be EUR 5m and zero for the remaining life.

**Figure 2: Interest rates applied to TLTRO III.4 and following operations.**




Source: ECB, Scope Ratings.

## TLTROs are now an established source of funding for banks

Recourse to ECB funding under TLTRO I and TLTRO II was often perceived as a sign of potential weakness. From a credit standpoint, recourse to central bank funding as a stable and core funding source along with customer deposits and medium-term wholesale debt was not a given. Indeed, banks in peripheral Europe increased their recourse to ECB funding to compensate for either lack of access to wholesale markets or access that was too costly.

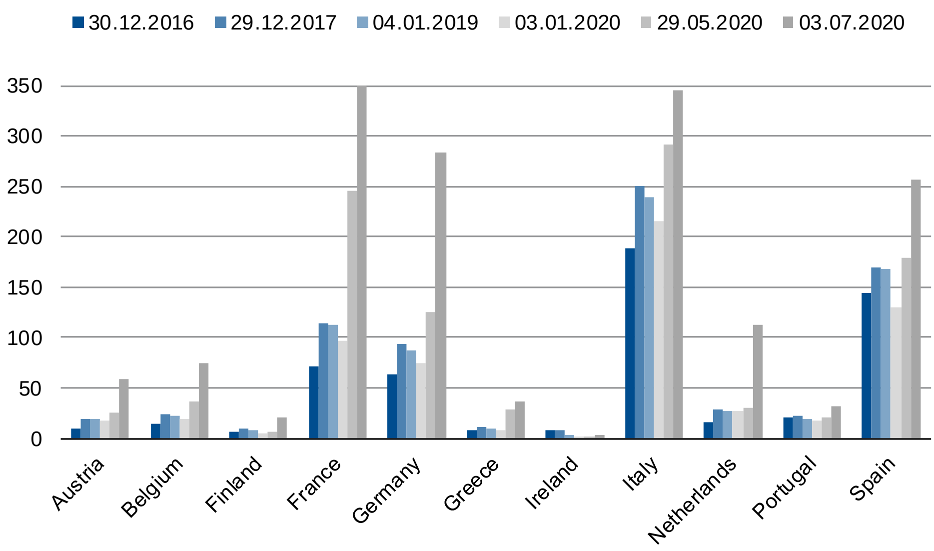
Banks in good shape had to claim that recourse to ECB funding was only opportunistic. They were also willing to demonstrate that voluntary repayment ahead of schedule was an easy task. As the expiry of TLTRO II lines approached in 2019, the ability of some peripheral banks to substitute central bank funding with wholesale financings was questioned. The announcement of TLTRO III put those concerns to rest.

**Allotted amounts have doubled with each TLTRO series**

The ECB also kept repeating that TLTROs were exceptional i.e. non-standard and temporary operations by nature. In the meantime, the gross amount of TLTRO funds nearly doubled between TLTRO I (above the EUR 400bn mark) and TLTRO II (close to EUR 800bn), and again with TLTRO III (total outstanding amount of LTROs getting close to EUR 1.6trn).

In the end, gradually increasing and repeatedly rolled-over LTRO facilities have gained a new status as an alternative refinancing tool for any bank. The subscriber list has expanded substantially – 742 bidders for the June 24 allotment. The geographic distribution of TLTRO funds has changed dramatically with TLTRO III.3 and III.4 especially when considering the relative participation by French and German banks.

**Figure 3: French and German banks are catching up with TLTRO III**




Source: ECB, Scope Ratings

**Increased reliance on ECB increases roll over expectation**

With the wider market acceptance of central bank funding and attractive pricing, we do not exclude a catch-up effect under forthcoming allotments, for instance from banks in Ireland. Given levels of excess liquidity (fuelled by TLTROs, other ECB support measures and precautionary customer savings on banks' balance sheets in the early part of 2020) some banks have already adjusted downward their funding plans for the rest of the year. In the meantime, increased reliance on central bank funding requires increased visibility on the roll over, or absence of roll over, of these operations.

Despite the wider acceptance of central bank funding as an alternative source of funding, transparency at the level of individual banks has room for improvement, especially for banks with large balance sheets. Some continue to be prudent, fearing adverse market perceptions. Attention has also shifted from recourse to central bank funding to the reputational issue of the ultimate use of funds – between carry trades at attractive rates and effective support to the real economy.

## TLTRO III.4 was not a liquidity rescue measure

The EUR 1.3trn TLTRO III.4 cash allotment took place just before the end of the second quarter. This provided a timely uplift to liquidity indicators. Did this cash inflow top up already large liquidity buffers or compensate for increasing pressure on liquidity buffers? We do not think it was intended to enhance pressured liquidity ratios even if it has the de facto virtue of pre-emptively neutralising liquidity risk for banks at large.

As early as March 2020, the ECB reiterated that banks were allowed ex ante to make use of their liquidity buffers given the stressed operating conditions. This would eventually lead banks to operate with regulatory liquidity coverage ratios (LCR) below 100%, the minimum required level since January 2018.

At that time, the ECB even indicated that it did not expect banks to make use of their liquidity buffers to comply once again with the general 100% minimum level any sooner than by the end of 2021. Reporting by the ECB and the EBA towards the end of the first quarter, amid very turbulent operating conditions for banks, did not point to a massive drop of liquidity for large institutions.

**Table 3: Reported LCRs for larger EU banks well above 100% at end Q12020**

| | Q1 2019 | Q2 2019 | Q3 2019 | Q4 2019 | Q1 2020 |
|---|---|---|---|---|---|
| **ECB: Liquidity Coverage Ratio for significant institutions** | 148.96% | 146.70% | 145.06% | 145.93% | 146.57% |
| **EBA: weighted average Liquidity Coverage Ratio** | 152.30% | 149.20% | 147.80% | 149.90% | 148.90% |

Source: ECB supervisory banking statistics, EBA risk dashboard, Scope Ratings.

So far, not a single bank has come under market attention because of a reported LCR below the 100% soft threshold. Beyond the actual potential stress level experienced by banks, this is partly because, in line with regulatory guidelines, most banks do not report spot LCRs but 12-month average ratios. By design, this approach smooths the impact of any abrupt change in the case of a tail-risk event.

A bank experiencing a severe drop of its spot LCR ratio to 80% in the last month of a quarter after 14 consecutive months at 125% – reflecting benign operating conditions – would still report a well preserved LCR ratio of 121.5% at the end of the quarter (average of 11 months at 125% and one month at 80%), versus 125% the preceding quarter (for the last 12 months at 125%).

**Table 4: Illustrative standard LCR reporting**

| | Total unweighted value (average) | | | | Total weighted value (average) | | | |
|---|---|---|---|---|---|---|---|---|
| Quarter ending on | 30/06 | 31/12 | 30/03 | 30/06 | 30/06 | 31/12 | 30/03 | 30/06 |
| Number of data points used in the calculation of averages | 12 | 12 | 12 | 12 | 12 | 12 | 12 | 12 |
| High-quality liquid assets (A) | | | | | 187.5 | 179.5 | 177.1 | 176.1 |
| Retail deposits and deposits from small business customers, of which: | 272.3 | 266.5 | 263.2 | 259.8 | 20.3 | 19.8 | 19.7 | 19.4 |
| Stable deposits | 166.0 | 164.5 | 163.9 | 162.6 | 8.3 | 8.2 | 8.2 | 8.1 |
| Less stable deposits | 106.3 | 102.1 | 99.3 | 97.2 | 12.0 | 11.6 | 11.5 | 11.3 |
| Unsecured wholesale funding | 244.7 | 237.2 | 234.4 | 233.1 | 116.3 | 114.0 | 113.4 | 113.4 |
| (…) | | | | | | | | |
| Total cash outflows (B) | | | | | 227.6 | 222.4 | 217.9 | 216.7 |
| Secured lending | 158.6 | 154.0 | 147.6 | 143.9 | 27.4 | 26.5 | 25.2 | 24.0 |
| Inflows from fully performing exposures | 49.0 | 49.2 | 49.8 | 49.5 | 34.7 | 34.8 | 35.1 | 34.6 |
| (…) | | | | | | | | |
| Total cash inflows (C) | 246.8 | 240.3 | 232.0 | 227.9 | 89.9 | 87.5 | 84.3 | 82.4 |
| **Liquidity buffer (A = Numerator)** | | | | | 187.5 | 179.5 | 177.1 | 176.1 |
| **Total net cash outflows (B-C = Denominator)** | | | | | 137.7 | 134.9 | 133.6 | 134.2 |
| **Liquidity coverage ratio (%)** | | | | | 136% | 133% | 133% | 131% |

Source: Scope Ratings

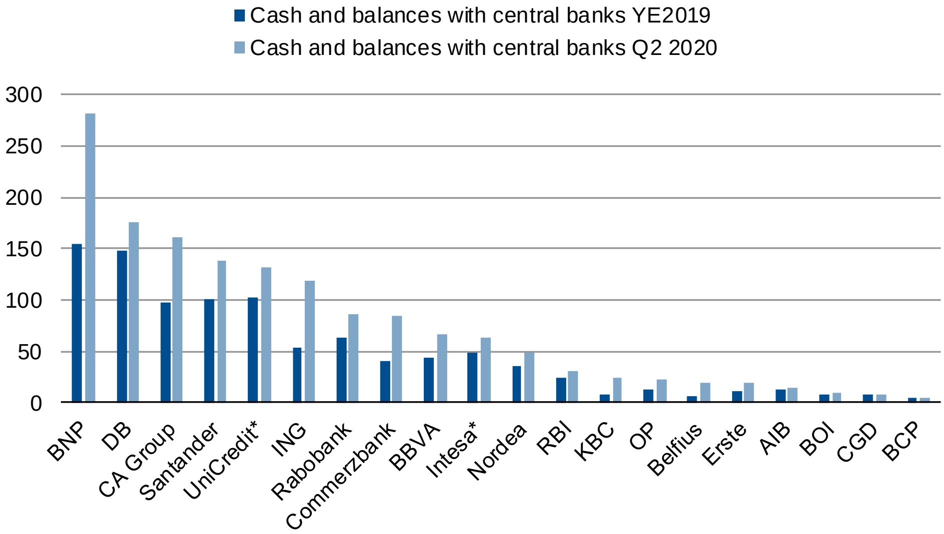
## TLTRO III.4 has fuelled liquidity reserves (for the moment)

**Excess liquidity means reinvestment challenges**

Although TLTRO III is designed to support bank lending in the long run, the timing was too short at the end of June for banks to find immediate investment opportunities. Most of it went back to central bank reserves or was invested in sovereign debt, increasing banks' Level 1 high-quality liquid assets (HQLA). In many countries, the inflation of liquidity reserves also results from large inflows of sight or short-term deposits from corporate and retail clients as part of precautionary savings.

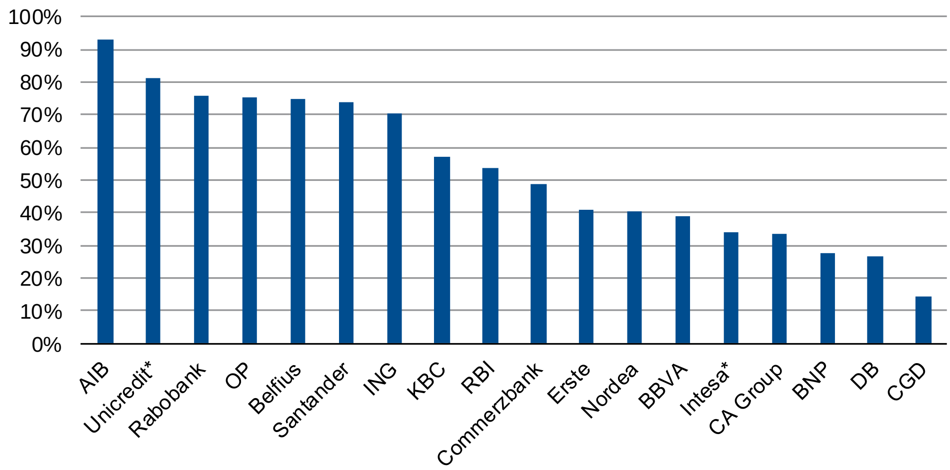
At the end of June 2020, most of the marked asset-side balance sheet increases came from placements with central banks (either reported under *cash and deposits with central banks* or under *interbank placements* in the case of Italian banks). Banks will obviously benefit from this carry trade.

**Figure 4: Evolution of central bank placements (Dec. 2019- June 2020)**




Note: For UniCredit and Intesa the figures are net interbank loans. Source: Banks reporting, Scope Ratings

**Figure 5: Evolution of central bank placements adjusted for asset growth (December 2019 – June 2020)**

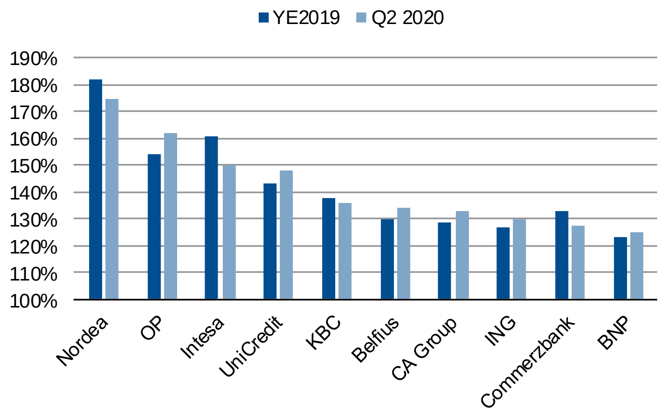



Note: For UniCredit and Intesa the figures are net interbank loans. Source: Banks reporting, Scope Ratings

As indicated, it will take time for 12-month average LCRs to reflect the material spot increase of HQLAs (the numerator of the LCR) boosted not only by the placement of TLTRO funds but also inflows of customer deposits for some banks. The gradual reinvestment in other less liquid asset classes, namely customer loans, will also contribute to the levelling of LCRs over time.

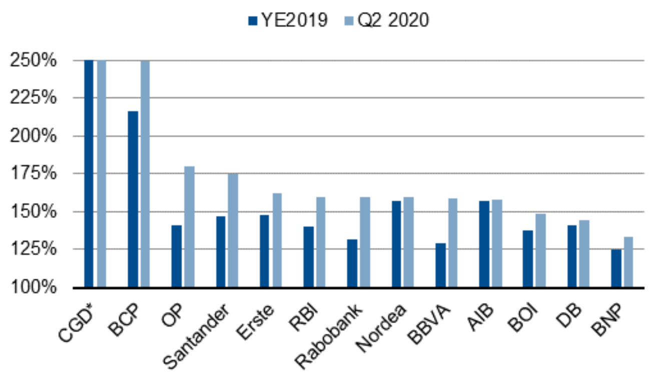
**Figure 6: Evolution of reported LCRs (selected banks)**

**12 m. average LCR**




Source: Banks reporting

**Spot LCR**




Note: *For CGD LCR at YE2019 331%, Q2 2020 402% Source: Banks reporting

TLTRO III has contributed to easing liquidity conditions for European banks. A potential identified shortfall of liquidity management focusing on LCR reporting relates to the identification of liquidity pressure in a single currency other than the currency used to report LCRs at consolidated group level.

For European banks, this is typically the case for dollar liquidity. Various window facilities in other currencies have been put in place since the beginning of the year. As a sign of easing conditions, we note that the ECB recently indicated that it planned to reduce the frequency of its seven-day US dollar liquidity operations as of 1 September from three time per week to once per week.

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