T-LTRO III: Take-up expectation and market impact

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- At its last meeting, the ECB announced a sizable reduction in T-LTRO III cost. Banks will pay 0.5% below the depo rate if they meet certain lending conditions and 0.5% below the MRO rate otherwise.
- The attractive pricing should lead to a large take-up: EUR 900-1,400bn gross and EUR 550-1,000bn net, adding the four operations. Net demand includes EUR 325bn already drawn from the bridge LTRO.
- As the more favorable pricing applies to the period June 2020 – June 2021, we expect strong front loading at the June operation (settlement 24 June 2020, maturity June 2023, results to be announced on 18 June).
- We expect that use of T-LTRO III liquidity will be more pronounced in the periphery than in core countries.
- The need to temporary park liquidity may benefit the short end of sovereign curves, in particular in the periphery, where credit premiums and liquidity parking needs are expected to be stronger. Past experience, however, suggests not to expect big moves in credit spreads.

1. June T-LTRO III: on your marks, get set, go!

Investors are increasingly focusing on the June T-LTRO III. In this note we summarize the key features of these liquidity operations, which have become very attractive since the improvement in pricing announced at the 30 April ECB meeting.

We then discuss our expectations for gross and net take up, which we expect to be high and widely dispersed across jurisdictions, with banks in the periphery more active in bidding TLTRO III funds.

We expect a modest impact on EUR money-market rates from additional liquidity. Temporary liquidity parking may benefit the short end of periphery curves, where carry is attractive and liquidity parking needs are expected to be more intense. Past experience suggests not to expect big moves in credit spreads.

2. Calendar of upcoming ECB liquidity operations

The schedule of ECB liquidity operations looks set to be quite busy in the coming months.

The next key date is the TLTRO III.4, which will settle on 24 June 2020 and mature in June 2023. Bids must be submitted by 9.30 CET on 17 June and allotment results will be published at 11.30 CET on 18 June. Moreover, on 22 June banks will have the chance to bid in the PELTRO, also with settlement 24 June.

The first PELTRO will be held earlier, on 20 May. Since this facility is a backstop and has a comparatively unattractive price, we expect a generally low take-up, particularly at the first operation.

The following table summarizes the entire calendar.

TABLE 1: CALENDAR OF UPCOMING ECB TENDERS

Type	Settlement	Maturity	Life (yrs)
LTRO - bridge	20-May-20	24-Jun-20	0.1
PELTRO	21-May-20	30-Sep-21	1.4
LTRO - bridge	27-May-20	24-Jun-20	0.1
LTRO - bridge	03-Jun-20	24-Jun-20	0.1
LTRO - bridge	10-Jun-20	24-Jun-20	0.0
T-LTRO III.4	24-Jun-20	29-Jun-23	3.0
PELTRO	24-Jun-20	30-Sep-21	1.3
PELTRO	06-Aug-20	30-Sep-21	1.2
PELTRO	03-Sep-20	26-Aug-21	1.0
T-LTRO III.5	30-Sep-20	28-Sep-23	3.0
PELTRO	08-Oct-20	26-Aug-21	0.9
PELTRO	05-Nov-20	29-Jul-21	0.7
PELTRO	03-Dec-20	29-Jul-21	0.7
T-LTRO III.6	16-Dec-20	21-Dec-23	3.0
T-LTRO III.7	24-Mar-21	29-Mar-24	3.0

Source: UniCredit Research

3. T-LTRO III: how it works and how much it costs

At its last two meetings, the ECB announced several improvements in conditions of the T-LTRO III

First it increased the amount available: Euro area banks can take up to 50% of their stock of eligible loans as of 28 February 2019 (up from 30% previously).

Second, it removed the limit of 10% of the stock of eligible loans for the amount of funds that can be borrowed in each operation so banks can, in principle, bid for all of their allowance in June.

Third, the lending performance threshold that needs to be met in the period from 1 March 2020 to 31 March 2021 in order to pay the minimum rate has been cut from 2.5% to 0%. Hence, banks will either pay the lowest rate or the highest.

Fourth, it introduced the possibility to repay funds early, from September 2021. The early repayment option is important because it increases flexibility and limits the period during which banks might face unfavorable funding costs. As a result, it creates an incentive to borrow even if a bank is unsure of beating the benchmark.

Finally, it has significantly reduce the cost of this operations. Banks will pay depo-0.50%, if they achieve positive lending in the period 1 March 2020-31 March 2021 and MRO-0.50% otherwise.

These conditions will apply in the period June 2020-June 2021, creating a strong incentive to front-load demand at the June operation. The remaining ones will benefit progressively less from the cheaper funding.

What happens to the cost after June 2021?

For banks that reach the lending threshold of 0% in the period 1 March 2020 – 31 March 2021, the most favorable conditions will be applied throughout the entire life of the operations. The interest rate applied before 24 June 2020 and after 23 June 2021 for these counterparties will be the average interest rate on the deposit facility over the life of the respective operation.

For banks that do not reach the lending threshold of 0% in this period 1 March 2020 – 31 March 2021, the original TLTRO III interest rates (between MRO and depo rate) and lending threshold, evaluated over the period between 1 April 2019 and 31 March 2021, will apply. The performance threshold will be lowered to 1.15%.

TABLE 2: T-LTRO III FUNDING CONDITIONS

	Beats benchmark	Does not beat benchmark
Jun 20 – Jun 21	-1.00%	-0.50%
Jun 21 – Sep 21	-0.50%	0.00%*
Average until first repayment date	-0.90%	-0.40%

Values assume no change in the depo rate

*considers the worst case where a bank does not exceed the lending threshold

Source: UniCredit Research

The effective cost of the operation will be known with certainty only once the evaluation period is over (31 March 2021).

These are the current economic conditions. As we have seen in recent months, it is possible that further changes are implemented in a way to keep financial conditions easy.

A bank that bids for liquidity and fails to qualify for the most favorable rate will pay (in the worst case) the MRO rate after June 21 and if it deposits funds at the ECB, it will incur in a negative annual carry of 50bp for the three months until September when it will be allowed to repay the funds.

On the other hand, banks that beat the benchmark will pay -1% and if they deposit at the ECB will obtain a 50bp carry until June 21 and 0bp afterwards.

4. Getting ready for the June T-LTRO III: what demand at ECB operation since March tells us

At its 18 March meeting, the ECB announced a series of weekly liquidity operations all with maturity of 24 June 2020, matching the settlement of the June T-LTRO III and with the cost set at the depo rate.

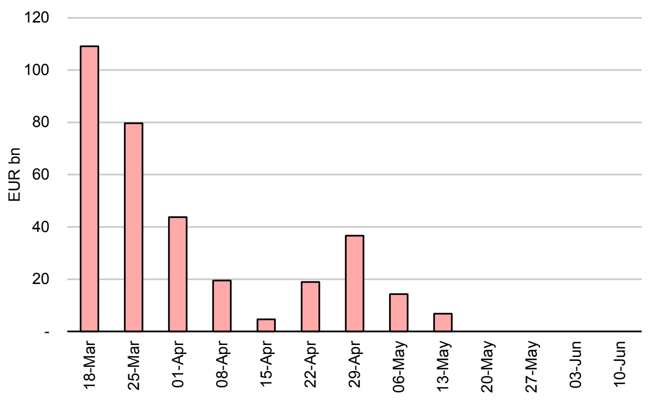
The these operations aimed to provide immediate liquidity support to banks and to safeguard money-market conditions.

This opportunity has been widely used by euro area banks, which have so far bid for EUR 328bn under these operations. This reflects precautionary demand for liquidity as well as preparations to meet higher liquidity demand from corporates.

More generally, this represents an anticipation of bidding in June, we expect the entire amount of liquidity bid for at the "bridge" LTRO to be rolled into the June T-LTRO III.

There are four more such operations planned, which will provide indications of banks' propensity to bid for additional liquidity. We do not expect a high additional take-up as liquidity uncertainty prevailing in March is over and the June T-LTRO III is now close. Chart 1 shows that demand has not increased since the announcement of more favorable conditions at the end of April.

CHART 1: DEMAND AT "BRIDGE" LTROS

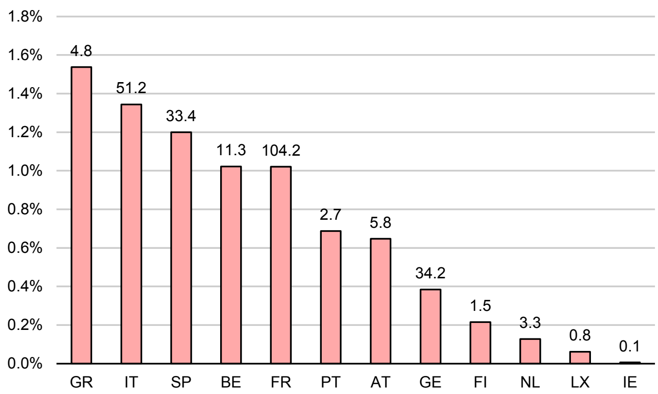


Source: ECB, Bloomberg, UniCredit Research

The ECB publishes a breakdown of total LTRO financing by country. What occurred in March sheds some light on banks' appetite for liquidity. The main caveat to consider is that it reflects bidding before the conditions were further improved at the end of April but that said, banks in core countries have shown a lower propensity to bid for liquidity.

Chart 2 shows the amount of T-LTRO bidding in March in the various euro area countries (which mainly refers to bridge operations and includes EUR 22bn of net bidding at the March T-LTRO III) normalized for the size of banking sector. Demand for liquidity by core countries has been moderate, while banks in the periphery have been more active. Demand from French banks has also been robust.

CHART 2: LIQUIDITY DEMAND IN MARCH



The chart shows demand for LTRO liquidity in March as a percentage of total assets. Numbers above the bars denote the amount of bidding in EUR bn

Source: ECB, Bloomberg, UniCredit Research

5. Estimating the take up at the T-LTRO III operations

There are several reasons to expect a large take up of T-LTRO III funds:

First, as highlighted in the last *Bank Lending Survey*, banks are anticipating strong demand for loans from corporates (see Chart of the Week – Eurozone banks brace for higher loan demand from firms, weaker demand from households, 28 April). TLTRO III funds can be used to meet such demand.

Second, given the very uncertain economic situation, precautionary demand for liquidity is also likely to be robust.

Third, deposits with the ECB with a maturity of longer than 12-months count for the NSFR. While this is not the most compelling reason to borrow, it is nevertheless positive, especially for banks that have difficult or expensive access to market funding.

Forth, the pricing of T-LTRO III is highly attractive and provides a sure carry for banks that expect to beat the benchmark.

So does this mean banks will draw the maximum amount available? Not necessarily. There are also reasons why banks may prefer not to use too much of this funding:

First, banks may face constraints because of collateral availability.

Second, TLTRO III funds have to be used somehow and this will increase RWAs, except if a banks keeps everything on the ECB deposit facility or buys sovereign bonds. This affects negatively the leverage ratio. Also higher RWAs pressure capital ratios and might lead to higher MREL requirements as the latter are calibrated on RWAs.

Third, while it is possible to draw the funds and leave them at the ECB deposit facility, earning the carry, banks may be concerned that there will be moral dissuasion in this respect and, with low visibility on the economic outlook, banks may prefer to wait before expanding their lending.

Finally, excess liquidity is highly dispersed across jurisdictions. Banks in core countries already have very abundant liquidity and may prefer not to have more, even if the T-LTRO III funds are very cheap.

All these factors will be considered by each bank individually and a top-down forecast for overall liquidity take-up is a very difficult exercise.

To do this, we start from the amount of funds that are available across the various jurisdictions.

TABLE 2: HOW MUCH T-LTRO III IS AVAILABLE

Country	Stock of eligible loans	Maximum TLTRO III borrowing	TLTRO up to Feb	Residual amt. at end Feb	Used in March -April*
GE	1511	755	74	681	46
NL	399	200	27	173	7
FI	122	61	5	56	2
LX	89	44	5	40	1
FR	1329	665	96	569	126
AT	235	118	17	101	8
BE	168	84	19	65	15
IE	78	39	2	37	0
IT	935	468	215	253	81
SP	638	319	130	189	52
PT	93	47	17	29	5
GR	108	54	8	46	6
Total	5706	2853	614	2239	349

*sum of LTRO operations plus EUR 22bn in net take-up at the March TLTRO III

Source: ECB, UniCredit Research

At the end of February, euro area banks had borrowed almost EUR 615bn through the LTRO, with EUR 2.2tn still available. The amount still available is widely dispersed across jurisdictions, with Germany and France being the countries with the most available (EUR 680bn and EUR 570bn, respectively).

As discussed above, banks in core countries have shown a lower propensity to increase their liquidity, while French banks and banks in the periphery have been more inclined to use the T-LTRO.

To obtain a range for the possible take up of TLTRO III as a whole, we consider the following two scenarios:

1. **Low take up:** Given that the level of excess liquidity is already high and visibility on lending is low, banks use a moderate share of what is available (15% in core countries and 60% in the periphery). This would be in line with the usage of T-LTRO II funds in the past, before the ECB rose the available amount.

2. **High take up:** Cheapness of funds prevails and banks make significant use of the instrument (30% in the core and 90% in the periphery). This would be considerably more than in the past.

Because the cost advantage of the T-LTRO ends in June 2021, there is a strong incentive to front-load demand. We expect as much as 60-80% of the total take-up to occur in June.

It should be considered that the EUR 352bn taken in March-May at the "bridge" LTRO represents an anticipation of June demand. Hence part of the increase in net liquidity has already occurred.

In estimating gross take-up, we note that it is extremely convenient for banks to roll over the old T-LTRO II into the new facility. There are almost EUR 420bn of funds still outstanding under this facility.

The following table summarizes our results.

TABLE 3: OUR EXPECTED TAKE-UP

	Total net	of which June		Total Gross	of which June	
Low take-up	569	341	455	986	759	872
High take-up	982	589	786	1399	1007	1203

Net take-up includes bidding already submitted at the weekly LTROs with maturity 24 June 2020

Source: UniCredit Research

6. Collateral issues

There are two questions regarding collateral. First, will banks have enough collateral to fully exploit their T-LTRO III allowance? Second, to what extent will high participation remove assets from the market with a potentially negative impact on liquidity?

With respect to the first question, on 7 April, the ECB announced an unprecedented set of collateral measures to mitigate the tightening of financial conditions across the euro area. Such measures should considerably ease concerns that banks may face constraints when bidding at the ECB operations. With respect to Italy, the Bank of Italy's stability report indicates that collateral available to banks amounted to EUR 250bn in March (not counting credit claims). Considering that Italian banks have EUR 250bn in unused T-LTRO III funds, collateral availability should not be an issue here.

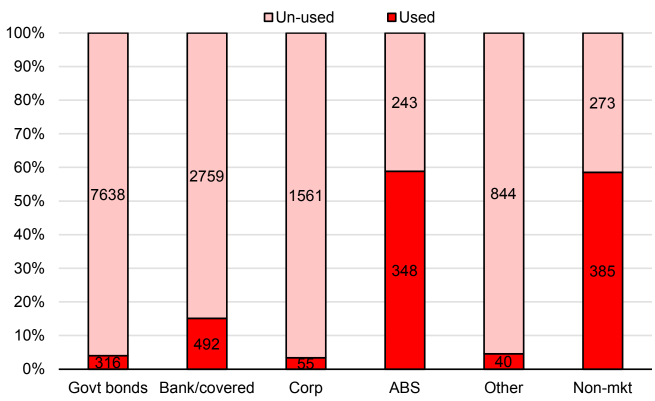
In other jurisdictions, availability of collateral may be less abundant. ECB data indicate that banks in core countries hold relatively small amounts of sovereign bonds. This may indicate that collateral availability could be more of an issue here.

With respect to the second question, data published by the ECB suggest that collateral availability in the system was ample; at the end of 1Q20 there was around EUR 500bn in ABS and credit claims still unencumbered. EUR 7.6tn of government bonds and 1.5tn of corporate bonds were still available.

Although not all of this is necessarily in banks' balance sheets, these are very large amounts, and multiples of what can be expected to be locked after the T-LTRO III.

That said, the usual caveat applies: these are aggregate data, which may mask significant differences from one jurisdiction to another.

CHART 3: COLLATERAL AVAILABILITY AND USE

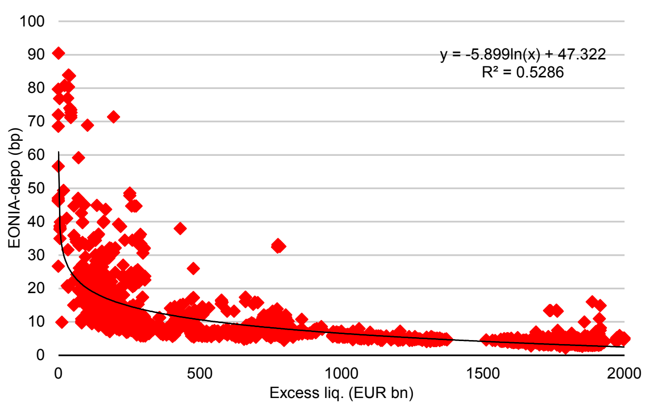


Source: ECB, UniCredit Research

7. What to expect on markets?

We expect a very modest impact on EUR money-market rates. OIS rates have already moved towards the depo rate as a result of high excess liquidity and the effect of additional excess liquidity is very small, as suggested by Chart 4. Using the relationship shown in Chart 4, an increase in excess liquidity of EUR 550-1,000bn would tighten the spread between EONIA and the depo by 2-4bp.

CHART 4: IMPACT OF ADDITIONAL EXCESS LIQUIDITY ON EONAI CLOSE TO ZERO



Source: Bloomberg, UniCredit Research

While it makes sense to analyze the historical relation based on EONIA, this benchmark has recently been substituted by €STR. Regarding the latter, we also expect a negligible impact from the T-LTRO III. €STR trades below the depo, reflecting the cost that banks with access to the ECB charge to accept the liquidity of counterparties with no access to the ECB. There is little reason to expect banks to charge more. Furthermore, as banks with access to the ECB still deposit their excess liquidity at -0.50%, there is little reason why €STR should decline.

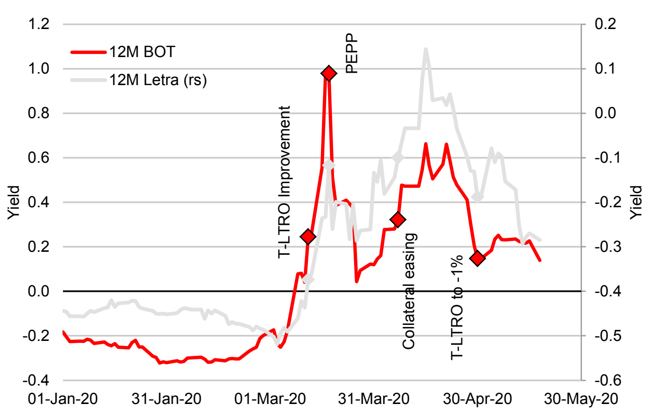
The effect on Euribor is more difficult to assess. A large take-up would put banks in a better position to meet demand for liquidity by end users, and this should ease stress in the market. If a large liquidity take-up leads to a revival in unsecured transactions, this should benefit Euribor fixings. Otherwise one should look for an indirect effect: improving sentiment may positively affect those market variables that drive Level 3 transactions– which is very difficult to assess.

What about credit spreads? While banks expect to gain better visibility on their lending, there will be a need to park the liquidity somewhere and this should increase demand for short-maturity assets. These liquidity parking needs are likely to be higher in jurisdictions with stronger T-LTRO III bidding. In addition to temporary liquidity parking, banks may want to use part of the liquidity for carry trades.

This was also a hot topic during past LTROs, but evidence that this led to meaningful credit spread tightening is not very strong and suggests caution in expecting strong moves as a result of ECB liquidity operations.

Recent price action does not suggest that the short end of the Italian or Spanish curves have moved much in anticipation of the upcoming liquidity. This is not too surprising as banks in periphery countries are already exposed to sovereign risk and do not wish to expose themselves to more of it.

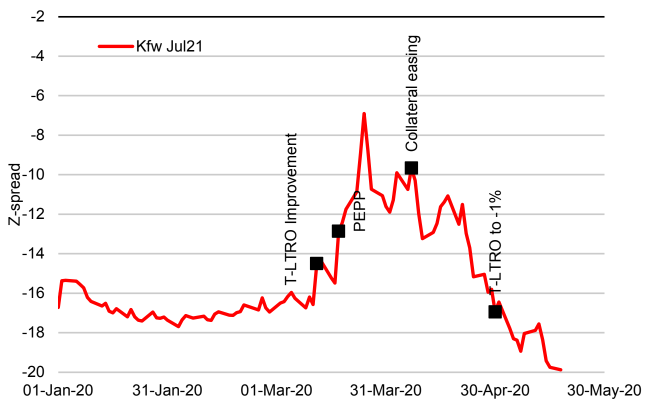
CHART 5: 12M IT AND SP YIELDS ARE NOT FRONT-RUNNING THE T-LTRO III



Source: Bloomberg, UniCredit Research

On the contrary, KfW and other SSA seem to have tightened more since the ECB announced the better pricing conditions at the end of April. This may be a hint that banks in core countries are buying these assets to set up carry trades.

CHART 6: KFW TIGTEHEND AFTER ECB ANNOUNCED T-LTRO COST REDUCTION



Source: Bloomberg, UniCredit Research

Rather than buying short-maturity assets outright, banks may deploy the liquidity in the repo market, where rates are currently higher than the T-LTRO III cost across jurisdictions. The increase in liquidity supply is likely to keep repo rates subdued.

To conclude, the following table summarizes the main options to generate carry. Banks with low probability of beat the benchmark will only gain by taking exposure to Italy. Banks that expect to beat the benchmark, even with a 50% probability, will have several options available.

TABLE 4: SEARCHING FOR OPTIONS TO GENERATE CARRY

		Bills 12M				2Y				Repo			
p(Q)	depo	GE	FR	IT	SP	GE	IT	SP	KfW	GE	FR	IT	SP
10%	-0.1%	-0.1%	0.0%	0.6%	0.2%	-0.2%	0.9%	0.2%	0.0%	-0.1%	-0.1%	0.0%	0.0%
20%	0.0%	0.0%	0.0%	0.6%	0.2%	-0.2%	1.0%	0.2%	0.1%	0.0%	0.0%	0.1%	0.1%
30%	0.1%	0.0%	0.1%	0.7%	0.3%	-0.1%	1.0%	0.3%	0.1%	0.0%	0.0%	0.1%	0.1%
40%	0.1%	0.1%	0.1%	0.7%	0.3%	-0.1%	1.1%	0.3%	0.2%	0.1%	0.1%	0.2%	0.2%
50%	0.2%	0.1%	0.2%	0.8%	0.4%	0.0%	1.1%	0.4%	0.2%	0.1%	0.1%	0.2%	0.2%
60%	0.2%	0.2%	0.2%	0.8%	0.4%	0.0%	1.2%	0.4%	0.3%	0.2%	0.2%	0.3%	0.3%
70%	0.3%	0.2%	0.3%	0.9%	0.5%	0.1%	1.2%	0.5%	0.3%	0.2%	0.2%	0.3%	0.3%
80%	0.3%	0.3%	0.3%	0.9%	0.5%	0.1%	1.3%	0.5%	0.4%	0.3%	0.3%	0.4%	0.4%
90%	0.4%	0.3%	0.4%	1.0%	0.6%	0.2%	1.3%	0.6%	0.4%	0.3%	0.3%	0.4%	0.4%
100%	0.4%	0.4%	0.4%	1.0%	0.6%	0.2%	1.4%	0.6%	0.5%	0.4%	0.4%	0.5%	0.5%

The table shows the difference between the yield of various instruments and the expected T-LTRO cost until September 21, depending on the probability of qualifying for the lowest rate.

Source: Bloomberg, UniCredit Research

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