Expect a large take at the final TLTRO II auction

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Important disclosures and certifications are contained from page 11 of this report
Expect a large take-up at the final TLTRO II auction

Demand on final TLTRO II likely to be boosted

- The allotment result of the fourth and final targeted longer term refinancing operations (TLTRO) II auction will be published on Thursday 23 March. **We expect a take-up of around EUR250bn.**

- The utilisation of TLTRO II has so far been EUR507bn, of which EUR401bn has been rolled from the previous TLTRO I. However, the total TLTRO II allowance is EUR1.693bn, implying the final auction has a very large potential take-up.

**We expect a boost to demand at the final auction due to the following.**

1. Banks have more information about the actual interest rate on the loan, as this depends on eligible net lending between February 2016 and January 2018.

2. It will be the final opportunity to acquire liquidity for four years at an interest rate that will not exceed 0% and is likely to be negative for most banks.

3. Since summer 2016, market expectations have changed in favour of pricing ECB hikes which, if they materialise, makes the TLTRO II even more attractive. The simplest ‘trade’ would be to place the TLTRO take-up at the deposit facility with upside if a rate hike occurs.

4. French banks worried about political uncertainty ahead of the presidential election could demand TLTRO II liquidity on fears of a potential capital flight.

TLTRO II utilisation has so far been modest

Source: ECB, Danske Bank Markets
Key facts about TLTRO II – benchmark not hard to beat

TLTRO II is much more attractive than TLTRO I

- TLTRO II provides very cheap bank funding with a long maturity and no mandatory early repayments.

- TLTRO II has a fixed size and maturity, while the price of the loans varies with eligible net lending.
  - **Size (fixed):** A total amount of up to EUR 1.693bn, which is 30% of eligible loans (loans to non-financial corporations and households excluding loans for house purchases) as at January 2016.
  - **Maturity (fixed):** Four years from settlement date with no mandatory early repayments but possible to repay after two years at a quarterly frequency.
  - **Price (variable):** Fixed at the MRO rate prevailing at the time of allotment but by exceeding the lending benchmark the rate can be as low as the deposit rate at the time of allotment

- For TLTRO I, the borrowing size and maturity depended on eligible net lending versus a specified benchmark whereas the price was fixed at MRO +10bp [see ECB easing – will it work? #1: ECB’s easing measures revisited, 25 August 2014].

### Key facts about TLTRO II loans

<table>
<thead>
<tr>
<th>Details about the ECB’s TLTRO II</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total eligible amount</strong></td>
</tr>
<tr>
<td><strong>Maturity</strong></td>
</tr>
<tr>
<td><strong>Repayments</strong></td>
</tr>
<tr>
<td><strong>Interest rate</strong></td>
</tr>
<tr>
<td><strong>Conditions for receiving a rate reduction</strong></td>
</tr>
<tr>
<td><strong>Benchmark (positive eligible net lending)</strong></td>
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<tr>
<td><strong>Benchmark (negative eligible net lending)</strong></td>
</tr>
<tr>
<td><strong>Auctions</strong></td>
</tr>
</tbody>
</table>

Source: ECB, Danske Bank Markets
The interest rate on TLTRO II loans depends on bank lending

TLTRO II interest rate depends on banks’ lending until January 2018 vs benchmark

TLTRO II interest rate can be as low as the deposit rate and not higher than MRO

Source: ECB, Danske Bank Markets

Source: ECB, Danske Bank Markets
Eligible net lending confirms the benchmark was not hard to beat

The lending benchmark should not be difficult to beat, implying the interest rate on the TLTRO II loan should be negative for most banks and close to -0.40% for many.

Given banks' eligible net lending up until January 2017 banks in Germany, France, Belgium, Finland and Ireland have exceeded 2.5% of the loan stock implying the TLTRO II interest rate on aggregate will be -0.40%. Given the lending up until January 2017, these countries could keep their lending unchanged or even decrease lending while still beating the 2.5% of the loan stock.

Banks in Italy, Spain, the Netherlands, Austria and Greece have also beaten their benchmark but not exceeded the 2.5% of loan stock, implying the interest rate on the TLTRO II in these countries will be between 0.0% and -0.40%. Only banks in Portugal have on aggregate not reached their benchmark, implying the interest rate on their TLTRO II loans is set to be 0.0%.

For most core countries, the benchmark was set at zero, while a large majority of the periphery countries could continue with declining lending and still get an interest rate on the TLTRO II loans as low as the deposit rate (see illustrations on next page).
Banks in core countries can expect a -40bp TLTRO II lending rate

Banks in periphery countries have beaten their benchmark but not reached 2.5%

The majority of banks across countries can expect a significant rate reduction

Source: ECB, Danske Bank Markets
Lending is currently set to beat the benchmark

On aggregate core countries are beating the 2.5% loan stock and set to get a -40bp rate

Periphery countries are also beating their negative benchmark but are not at 2.5%

Source: ECB, Danske Bank Markets
Banks are still able to borrow a large amount on TLTRO II

Euro area banks are able to borrow a total of EUR1.692bn on TLTRO II

<table>
<thead>
<tr>
<th></th>
<th>MFI eligible loan stock* (Jan-16)</th>
<th>TLTRO II allowance (30% of eligible loan stock)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All figures are in EUR bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Euro Area</td>
<td>5,642</td>
<td>1,692</td>
</tr>
<tr>
<td>Germany</td>
<td>1,356</td>
<td>407</td>
</tr>
<tr>
<td>France</td>
<td>1,166</td>
<td>350</td>
</tr>
<tr>
<td>Netherlands</td>
<td>436</td>
<td>131</td>
</tr>
<tr>
<td>Belgium</td>
<td>138</td>
<td>41</td>
</tr>
<tr>
<td>Austria</td>
<td>214</td>
<td>64</td>
</tr>
<tr>
<td>Finland</td>
<td>105</td>
<td>32</td>
</tr>
<tr>
<td>Core countries</td>
<td>3,414</td>
<td>1,024</td>
</tr>
<tr>
<td>Italy</td>
<td>1,056</td>
<td>317</td>
</tr>
<tr>
<td>Spain</td>
<td>690</td>
<td>207</td>
</tr>
<tr>
<td>Greece</td>
<td>131</td>
<td>39</td>
</tr>
<tr>
<td>Portugal</td>
<td>104</td>
<td>31</td>
</tr>
<tr>
<td>Ireland</td>
<td>71.0</td>
<td>21</td>
</tr>
<tr>
<td>Periphery countries</td>
<td>2,052</td>
<td>616</td>
</tr>
<tr>
<td>Other EA countries</td>
<td>175</td>
<td>53</td>
</tr>
</tbody>
</table>

Most core countries have a benchmark at zero – in the periphery it is negative

A positive figure in the chart implies the banks in the country on aggregate have a benchmark set at zero.

A negative figure in the chart implies the banks in the country on aggregate have a negative benchmark equal to the eligible net lending.

Source: ECB, Danske Bank Markets
The transmission mechanism has ‘never worked better’

Very low private sector cost of borrowing

Recovery in private sector lending continues

Source: ECB, Danske Bank Markets
**TLTRO II: Why banks will use it and possible market implications**

Demand for final TLTRO II likely to be boosted

- A number of factors speak in favour of a high utilisation of the final TLTRO II:
  1. The money market is now pricing multiple rate hikes within the maturity of TLTRO IIs and, together with the prospect of realising a very low TLTRO II interest rate, this makes the loan very attractive. This is because it is possible banks will be able to place liquidity at a higher rate than the -40bp.
  2. The option value of securing cheap funding has increased given the high political risk, risk of capital flights from some regions and a euro break-up as the worst outcome.
  3. It will be the final opportunity to acquire very cheap funding for as long as four years.
  4. Bond ‘carry’ trade despite being less attractive this time around.

- The overall purpose of the TLTRO IIs is to boost bank lending to the real economy by providing banks with funding at very favourable rates. Whether this has actually happened is not clear cut.

- On the right, we list some of the possible considerations of a bank treasury when determining their TLTRO take up.

Possible considerations of a bank treasury:

1. **Higher rates to come**
   Market expectations are that the ECB will hike rates in the short term, making it possible to place TLTRO II proceeds at the deposit facility at a higher rate than the TLTRO II lending rate. **Market impact**: None.

2. **Option value**
   With political risk looming and a potential euro break-up the worst outcome, the optionality of securing funding now has increased. **Market impact**: None.

3. **Cheap funding**
   Take-up for funding purposes will cause banks to swap their fixed liabilities to a floating, due to ALM considerations, by receiving 4Y swap (versus 3M Euribor). **Market impact**: Lower swaps (versus 3s).

4. **The bond ‘carry’ trade**
   Buying 4Y Italy, Spain and France, all yielding above any expected TLTRO II rate, provides a ‘basket’ with a nice yield pickup. This was the main reason for using the original LTROs in 2011. However, this carry trade has become far less attractive this time around. **Market impact**: Lower periphery yields.
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