ECB's lower *ad infinitum*

- 'Lower for longer' is now official
- The changes in the TLTRO conditions will be particularly supportive for weaker European banks, and will reduce bond issuance volumes in the next 12 months
- Tiering will have a modestly positive on banks in Germany, France and Netherlands

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Positive relief measures from the ECB, yet damage from negative rates will continue

The main message from yesterday's announcements by the ECB is that the negative rate on the central bank's main deposit facility, which has been negative since June 2014, will remain negative for years to come. Even though some relief was provided in the form of better conditions on TLTROs and the belated implementation of tiering, the already weak profitability of euro area retail banking will continue to deteriorate. The introduction of tiering will have a direct positive - albeit somewhat limited - impact for banks in Germany, France and Netherlands in particular, which hold the vast majority of excess liquidity at the central bank. Yet banks will continue to be penalized for taking on deposits, which distorts banks' very reason of being. That said, the changes in the TLTRO conditions will provide strong support to wholesale funding conditions for weaker euro area banks, which may prove vital amid the many political risks across the area and deteriorating economic outlook.

Interest Rates: *10bps cut in the deposit rate to -0.50%, forward guidance kept open the door to further rate cuts until the inflation outlook "robustly" converges to target.*

The new forward guidance is a credit negative. It makes the 'lower for longer' environment official. Given the weak and downgraded economic outlook, it is clear that euro area banks will have to work with negative interest rates for several years to come. Profitability from retail banking operations will deteriorate further, the operational viability of several banks will remain under question, particularly in Germany. Further cost cuts will be needed. Weak profitability means euro area banks will be poorly positioned for a potential recession in the region.

Quantitative Easing relaunch: *monthly net purchase amounting to €20bn from 1 November, open-ended, to continue until just before rates start to go up goes well beyond expectations*

Based on technicals only, this should maintain the pressure on European bank spreads and yield, although the monthly volume announced is lower than market expectations. The restart of QE and likely increasing scarcity of debt securities the ECB is allowed to buy will crowd out investors from safer assets, indirectly increasing the demand for banks' unsecured papers, which should trickle down the capital structure.

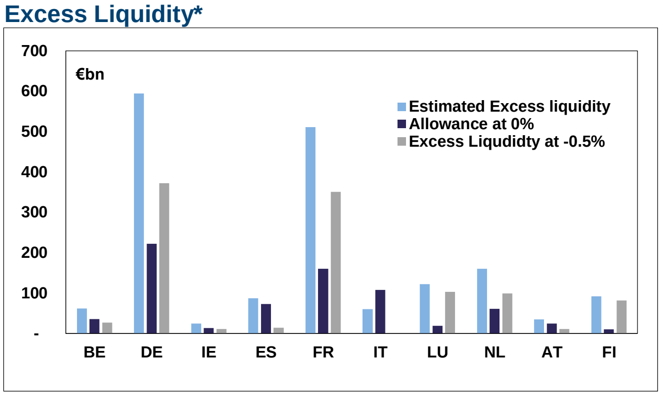
TLTRO III: *Maturity changed from 2 to 3 years, with early repayment allowed after 2 years, pricing moved from between 0.10% (MRO + 10bps) and -0.3% (deposit facility price +10bps), to 0.0% (MRO) and -0.5% (deposit facility price).*

The improved conditions, from the perspectives of both pricing as well as maturity, will make euro area banks more willing to take on the new round of TLTRO, even those that were not considering it until yesterday. This will likely have a negative impact on the total volume of bonds issued by euro area banks in the next 12 months. Although the measure is meant to support lending, in reality it will be very positive for smaller banks with reduced market access, which will likely struggle to reduce their reliance on ECB funding.

Tiering*: Excess liquidity placed at the central bank amounting to less than 6 times minimum reserve requirements will be exempt from the -0.5% deposit rate. The remuneration rate of the exempt tier and the multiplier can be changed over time.*

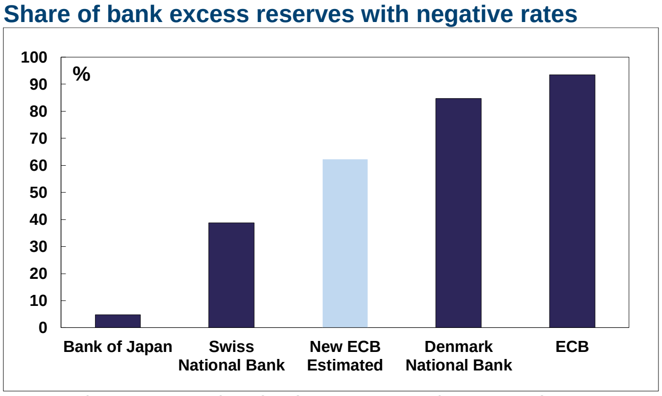
The implementation of tiering is sensible, even if belated, yet our initial calculations show that initial impact will be limited from a profitability perspective. Assuming constant levels of excess liquidity, and that banks will move their excess reserves from the deposit facility to the current account facility, they will now pay about €5.6bn per year to the ECB according to our estimates, down from the €7.1bn paid in 2018.

Excess Liquidity*



Data as of end-July 2019. Source: ECB and Daiwa Capital Markets Limited. * Assuming banks will move their deposits from the deposit facility to the current account facility.

Share of bank excess reserves with negative rates



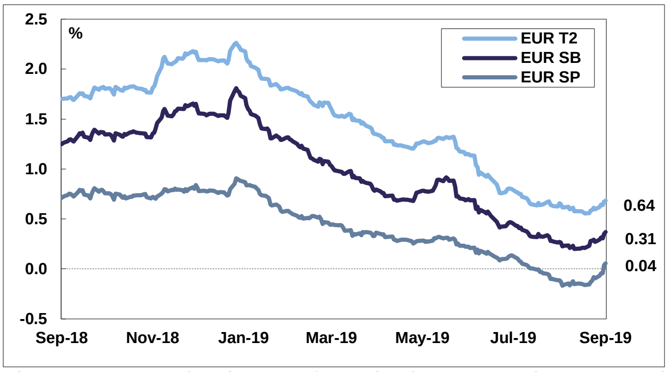
Data as of end-July 2019 for ECB, September 2019 for BoJ and SNB, and May 2019 for BoJ. Source: Central Banks and Daiwa Capital Markets Limited.

We estimate that around 35-40% of the current excess liquidity of €1.8tn will become exempt from paying the ECB's deposit rate. Banks from Germany, France, the Netherlands and Luxembourg, which account for the lion's share of excess reserves, will benefit the most. Italian banks, meanwhile, will have around €50bn of liquidity they could still place at the ECB at no extra cost. The measure has reduced the relative attractiveness of bonds relative to excess funds deposited at the ECB, which has led to a sell-off of shorter-dated government bonds.

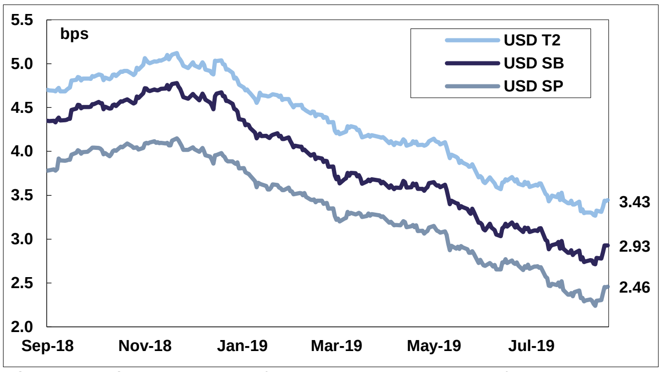
Market Reaction

Taking their prompt from sovereigns, European bank yields rose sharply yesterday, and continue to do so this morning. After being in negative territory since end-July 2019, the average yield on EUR Senior Preferred paper is now back in the black, at 0.04%. USD yields followed a similar pattern. The stock market was very volatile during the day, impacted by a wide range of factors, including suggestions of a further easing of US–China trade tensions. But while the SX7P closed marginally down at -0.07%, it has opened higher this morning.

Average EUR Yields[1]



Average USD Yields[1]



Source: Bloomberg. SP= Senior Preferred; SB=Senior Bail-in (Senior Non-Preferred, Senior HoldCo). Not adjusted for duration. Herein included figures may not be reflective of the whole market. [1]Average Yield to call/maturity of the largest European banks' debt securities across maturities.

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