Euro area financial integration

Karl-Heinz Riehm, Unicredit
Ingo Mainert, EFAMA / Allianz Global Investors
Zoeb Sachee, Citigroup

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ECB – Bond Market Contact Group
I. The Funding Perspective

General Assessment

• Dislocated money market
• No unsecured interbank market, even o/n market limited
• Repo with "periphery banks" in "periphery collateral" difficult or not possible
• Higher haircut e.g. GC pooling, LCH
• Strong ECB dependence
• Diverged funding levels e.g. 12m MM UC S.P.A Euribor +23bp
I. The Funding Perspective

5Y CDS HVB and UCGIM

Source: UniCredit Research
I. The Funding Perspective

HVB Pfandbrief and UCGIM OBG

Source: UniCredit Research
II. The Investor Perspective

Executive Summary

• 3 Phases of European Area Financial Integration
  Phase 1 - Convergence (1999 – 2007): Switch from local to European benchmarks
  Phase 3 – Readjustment (Mid 2012 – today): Still focus on local benchmarks with strong focus on ratings and liquidity

• „Target2“ still shows fragmentation despite some stabilisation

• Commercial Banks reallocate to domestic debt

• Duration positioning: close to benchmark with bias to short duration

• Country weights: still long exposure to peripherals vs. core countries despite spread widening
## II. The Investor Perspective

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>1 - 3 Years</th>
<th>3 - 5 Years</th>
<th>5 – 7 Years</th>
<th>7 - 10 Years</th>
<th>10+ Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euroland</td>
<td>0.11 (11.16)</td>
<td>0.00 (1.67)</td>
<td>0.13 (8.17)</td>
<td>0.40 (11.81)</td>
<td>0.21 (14.47)</td>
<td>-0.63 (17.76)</td>
</tr>
<tr>
<td>Germany</td>
<td>-1.55 (4.52)</td>
<td>-0.23 (0.46)</td>
<td>-0.85 (2.65)</td>
<td>-1.14 (4.83)</td>
<td>-1.38 (6.85)</td>
<td>-3.62 (8.60)</td>
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<tr>
<td>France</td>
<td>-1.41 (10.19)</td>
<td>-0.27 (2.35)</td>
<td>-1.09 (7.30)</td>
<td>-1.25 (11.32)</td>
<td>-1.11 (14.01)</td>
<td>-3.16 (16.43)</td>
</tr>
<tr>
<td>Italy</td>
<td>2.05 (21.01)</td>
<td>1.37 (9.65)</td>
<td>1.37 (17.12)</td>
<td>1.78 (21.22)</td>
<td>2.15 (25.14)</td>
<td>3.20 (32.07)</td>
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<tr>
<td>Spain</td>
<td>5.32 (6.04)</td>
<td>2.75 (5.61)</td>
<td>3.89 (6.40)</td>
<td>5.48 (7.38)</td>
<td>6.80 (5.19)</td>
<td>9.21 (7.80)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>-2.03 (5.94)</td>
<td>-0.21 (1.17)</td>
<td>-1.18 (4.66)</td>
<td>-1.58 (7.08)</td>
<td>-2.31 (8.69)</td>
<td>-4.72 (8.70)</td>
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<tr>
<td>Belgium</td>
<td>-2.14 (16.67)</td>
<td>-0.38 (5.65)</td>
<td>-1.21 (12.67)</td>
<td>-1.83 (17.45)</td>
<td>-1.99 (21.76)</td>
<td>-4.28 (25.60)</td>
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<tr>
<td>Austria</td>
<td>-1.20 (10.78)</td>
<td>-0.10 (2.20)</td>
<td>-0.72 (7.00)</td>
<td>-0.98 (11.77)</td>
<td>-1.01 (13.93)</td>
<td>-0.73 (8.50)</td>
</tr>
<tr>
<td>Finland</td>
<td>-1.88 (7.30)</td>
<td>-0.36 (1.15)</td>
<td>-1.32 (4.55)</td>
<td>-1.96 (8.25)</td>
<td>-2.42 (10.02)</td>
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<tr>
<td>Ireland</td>
<td>5.53 (29.31)</td>
<td>1.14 (14.99)</td>
<td>2.86 (24.73)</td>
<td>5.25 (32.84)</td>
<td>6.63 (34.20)</td>
<td>8.96 (36.42)</td>
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<tr>
<td>Portugal</td>
<td>4.34 (58.14)</td>
<td>2.10 (35.87)</td>
<td>2.57 (53.90)</td>
<td>5.76 (79.30)</td>
<td>6.62 (75.71)</td>
<td>8.10 (68.58)</td>
</tr>
</tbody>
</table>

### Segment Performance

<table>
<thead>
<tr>
<th>Segment</th>
<th>2013 Performance in % (2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro Corporates All (IG)</td>
<td>0.12 (13.60)</td>
</tr>
<tr>
<td>Euro Collaterized</td>
<td>1.32 (11.39)</td>
</tr>
<tr>
<td>Euro Sub Sovereigns</td>
<td>-0.19 (8.75)</td>
</tr>
<tr>
<td>Euro High Yield</td>
<td>2.05 (27.19)</td>
</tr>
<tr>
<td>Emerging Markets (EMBI+; USD)</td>
<td>-9.36 (18.04)</td>
</tr>
</tbody>
</table>

## II. The Investor Perspective

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Convergence</strong></td>
<td><strong>Divergence</strong></td>
<td><strong>Readjustment</strong></td>
</tr>
<tr>
<td><em>Euro-Euphoria/Enthusiasm</em></td>
<td><em>Euro-Hysteria/Scepticism</em></td>
<td><em>Euro-Realism/Disillusion</em></td>
</tr>
<tr>
<td>Switch from local to European benchmarks</td>
<td>Refocusing on local benchmarks</td>
<td>Still a tendency to local benchmarks with strong focus on ratings and liquidity.</td>
</tr>
<tr>
<td>Equities: EuroSTOXX, STOXX</td>
<td>Equities: DAX, CAC40, IBEX ..</td>
<td>Equities: DAX, CAC 40, IBEX…</td>
</tr>
<tr>
<td>Bonds: JPM EMU, iboxx Eurozone</td>
<td>Bonds: iboxx/JPM Germany, Italy, Spain …</td>
<td>Bonds: iboxx/JPM Germany, Italy, Spain …</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial Transaction Taxes</td>
</tr>
</tbody>
</table>
II. The Investor Perspective
Reallocation to Domestic Debt – My Home is My Castle

Proportion (in %) of Domestic Government Bonds to all Government Bonds held by Commercial Banks

Source: Ifo-Institut. May 2013
II. The Investor Perspective

Investor positions have barely changed from the last survey

Investors kept their long exposure to peripherals vs. core countries over the past two weeks broadly unchanged

**Duration deviation from the benchmark in years**

**Euro area single-currency:** -0.20 years

**Net exposure of Euro area investors to peripherals vs. core; %**

**European duration survey results**

Duration deviation from the benchmark in years

<table>
<thead>
<tr>
<th>Duration deviation from the benchmark in years</th>
<th>Multi-currency investors</th>
<th>Single-currency investors</th>
<th>Peripherals vs. core</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>0.08</td>
<td>(0.01)</td>
<td>(0.00)</td>
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<tr>
<td></td>
<td>0.12</td>
<td>(0.14)</td>
<td>(0.01)</td>
</tr>
<tr>
<td></td>
<td>0.15</td>
<td>(0.02)</td>
<td>(0.00)</td>
</tr>
</tbody>
</table>


**Duration:**

Close to benchmark with short duration bias.

**Country weights:**

Still long exposure to peripherals vs. core countries despite spread widening.
III. The Dealer Perspective
The Role of Banks in Fragmenting the EGB Market

Heavy LTRO usage in periphery → Fragmentation of the domestic demand patterns

Source: ECB, Citi Research
III. The Dealer Perspective

Trends in Foreign EGB Market Participation

Fragmentation of the non-resident demand patterns for core and non-core bonds

Non-resident share of French govies is stable throughout the crisis

Non-resident investors have liquidated Italian govies between 2011 and 2012...Draghi’s OMT has been key in stabilising foreign demand

Source: AFT, Bank of Italy, Citi Research
III. The Dealer Perspective
Real Fragmentation: Italy and Spain

Credit to real-sectors is contracting, house prices are falling. Rising youth unemployment

In Italy, lending to non-financials is back to levels seen in mid-2010 (-4% yoy), while NPLs rise at a rate of 20% yoy (now 6% of total loans)

House Prices are back to 2004 levels in Spain
Loans to households drifting lower

Divergence in labour markets, with striking contrast in youth unemployment versus Germany

Source: Bank of Italy, Citi Research
III. The Dealer Perspective

Dealer capacity to hold inventory in periphery has been impacted by several factors

- Changes in Risk Management
- Impact of Rating Downgrades
- Volatility has led to liquidity fragmentation
- Wider bid-offer spreads in periphery than core
### III. The Dealer Perspective

#### Credit Rating Fragmentation

EGBs…from AAA to almost sub-IG

![Graph showing yield vs. rating score for various EGBs]

<table>
<thead>
<tr>
<th>Isin</th>
<th>Bond</th>
<th>Maturity</th>
<th>Yield</th>
<th>ASW</th>
<th>S&amp;P</th>
<th>Moody's</th>
<th>Fitch</th>
<th>DBRS</th>
<th>Score</th>
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<tbody>
<tr>
<td>EI966444 Corp</td>
<td>RAGB 3 4 11/22/22</td>
<td>9.5</td>
<td>1.79</td>
<td>8</td>
<td>AA+</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
<td>1.3</td>
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<tr>
<td>EI962882 Corp</td>
<td>BGB 4 1/4 09/28/22</td>
<td>9.3</td>
<td>2.15</td>
<td>51</td>
<td>AA</td>
<td>Aa3</td>
<td>AA</td>
<td>AAH</td>
<td>3.0</td>
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<tr>
<td>EJ341415 Corp</td>
<td>RFG 1 5/8 09/15/22</td>
<td>9.3</td>
<td>1.70</td>
<td>-2</td>
<td>AAA</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
<td>1.0</td>
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<tr>
<td>EJ384577 Corp</td>
<td>FRTR 2 1/4 10/25/22</td>
<td>9.4</td>
<td>2.02</td>
<td>29</td>
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<td>Aa1</td>
<td>AAA</td>
<td>AAH</td>
<td>1.8</td>
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<td>EJ342271 Corp</td>
<td>DBR 1 1/2 09/04/22</td>
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<td>AAA</td>
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<td>EJ341690 Corp</td>
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<td>9.4</td>
<td>4.20</td>
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<td>BBB+</td>
<td>Baa2</td>
<td>BBB+</td>
<td>AL</td>
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<td>EJ006215 Corp</td>
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<td>9.1</td>
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<td>EJ525879 Corp</td>
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<td>Baa3</td>
<td>BBB</td>
<td>AL</td>
<td>9.0</td>
</tr>
</tbody>
</table>

Source: Citi Research
III. The Dealer Perspective
Liquidity Fragmentation

Volatility having a disproportionate effect on the liquidity of peripheral markets

Realised volatility between core and non-core has had a differential impact on VAR – both for dealers and end users of EGBs

Higher vol has translated into lower inventory, lower liquidity and wider bid/ask spreads for peripheral EGBs

Source: MTS, Citi Research
Discussion Topics

• Different funding approach
• Different bank lending policy
  - access to credits at reasonable levels limited to top rated borrowers who are accepted cross border
• Increased divergence of the economies
• Steps towards ‘reintegration’
• Impact of regulation
• Recent developments on banking union
• Too low rates in N Europe – leading to ‘bubble’?
Euro area financial integration – Appendix

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Frankfurt am Main, 09 July 2013

ECB – Bond Market Contact Group
TARGET2 still shows fragmentation despite stabilisation (%GDP)

Source: Allianz Global Investors Europe GmbH, national central banks (latest data available), Bloomberg, data as per 04.06.2013
Yield Curves: Germany, France, Italy; Spain; Ireland and Portugal, 28.06.2013

Source: Allianz Global Investors Europe GmbH. Past performance is not a reliable indicator of future results. Data as of 28.06.2013
Fragmentation – reversible or permanent?

Path towards re-integration will take time and require much more than just Central Bank actions

- Fragmentation, or ‘home bias’ has created stability in politically turbulent environment (e.g. Italy, Cyprus)
- In recent bond market sell-off, periphery has been trading more like a Rates market than Credit Market
- Risk appetite for periphery has increased in line with lower volatility. But investors still constrained by ratings and regulation
- Re-integration will require structural reform and steps to improve competitiveness, in order to achieve better ratings – not the mandate of ECB.
- Central Banks could have some impact on minimizing volatility through market intervention
Core vs Periphery: Correlation

Heavy positioning and changing risk premia is distorting correlations

Large increase in the correlation between core and non-core in recent sessions.

Source: Bloomberg, Citi Research