FOLLOW UP ON EUROPEAN COLLATERAL SCARCITY

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# AGENDA

1. **Reminder of Last Year Situation**
2. **Measures Taken (German DMO / Eurosystem) and German Issuance Evolution**
3. **An Improved Situation**
4. **Impact of ECB Announcement on Gov. Deposits on European T-Bills**
Following extremely tense first three quarters of 2022, most of the indicators showing collateral scarcity in Europe, notably for German debt, have strongly eased over Q4 2022 and Q1 2023

- German Repo levels have retraced to quasi pre-crisis levels
- Levels of German debt yield spreads vs swaps have strongly retraced but not yet completely normalised

These improvements are the result of joint actions from:

- German Finance Agency (GFA) to ease the repo market tensions
- ECB normalising monetary policy. In particular, reducing excess liquidity and paving the way for QT
- German government to increase fiscal spending therefore raising strongly expectations of higher supply of German debt

Nevertheless, market could still be proven fragile, notably would the current anticipations of QT be challenged, as the level of floating of German debt remains very low
I - REMINDER OF LAST YEAR SITUATION

- **General scarcity of collateral**
  - Due to specific pandemic-related conditions like PEPP and TLTRO

- **Opportunities for leveraged trades**
  - Excess leverage in the system
  - Short basis (short bonds vs futures) – QE intermediation
  - Rich asset swap
  - Fast money short positioning into end of PEPP and APP

- **Potential issues from Official Institutions (OI) / governments reserves management as rates go up**

- Floating estimated to below 30% for Germany
- Squeezed repo
  - Level
  - Number of bonds highly special
  - Bond futures basis levels and volatility
- Squeezed asset swap (ASW) and dislocated asset swap curve on Off the runs
- Bund futures reduced liquidity and ASW volatility
  - Increased cost of hedging for end users
II – A COMBINATION OF MEASURES BY ALL ACTORS

- The situation required exceptional answers from all actors in order to
  - Increase the supply of German collateral in Repo
  - Stop the decrease of the floating of German and other core gov. bonds
  - Increase the future supply of German bonds

- All issues were addressed to a certain extent
  - German DMO and ECB increased the available collateral for bilateral repo with dealers
  - ECB addressed the 2 main factors behind bonds scarcity
    - QE and TLTRO
  - German government changed the dynamics of the German debt by engaging into Green and Defense related spending
Record high net supply net of QT forecasted for this year, more than triple last year*

*We assume QT starts from March with the ECB reducing reinvestments by 50%, consistent with the EUR15bn/m pace announced by the ECB. We only consider EGBs. From July we assume a complete end to reinvestments. Sources: National Treasuries, ECB, BNP Paribas

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The Bund Free Floating issue

Eurosystem holds around 40% of public sector debt we estimate

With the return of collateral, repo rates have started to cheapen

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Sources: RepoFundsRates, National Treasuries, ECB, BNP Paribas

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The bank for a changing world
Beginning of 2022 German finance agency announced it would address any potential collateral squeeze and support smooth functioning of repo markets

- Buba discussed increasing counterparty limits to alleviate the degree of specialness
- ECB actioned the following
  - ECB increasing amount borrowed vs cash from €75bn to €150bn
  - ECB (via Deutsche security lending) also increasing counterparty limits

Feb 3rd 2022: Specific mitigation for Mar 24 Schatz, German finance agency to increase holdings of Mar 24 Schatz by €2.5 billion to €8.5 billion, with volume to be used exclusively for short-term repo and securities lending transactions

Oct 19th 2022: 54 bn increase of Germany finance agency own holdings for repo: 3bn for 18bonds (Interdealer Brokertec 100bn per day)
  - This measure, published soon before TLTRO recalibration, strongly helped the market
ECB decisions / announcements since March 2022

- March 10th 2022:
  - APP size to be reduced from 40bn in April to 20 Bn in June and then will be data dependant
  - PEPP to stop net asset buying from end of March
- March 24th 2022: timeline to gradual phase out of the temporary pandemic collateral easing measures
- June 15th 2022: APP net asset purchases to end starting July 1st 2022
- July 18th 2022: creation of the TPI (Transmission Protection Instrument)
- Sep 8th 2022
  - Ceiling for remuneration of government deposits to be Min (DFR, €STR), ECB temporarily removes 0% interest rate ceiling
  - P Lane mentioned an holistic approach for Non European OI deposits in his speech at MMCG (Sep 15th)
- Oct 27th 2022
  - TLTRO III recalibration: interest rate of TLTRO to be indexed ECB key rates from November 23rd 2022 removing the incentive to keep TLTRO for many banks, 3 repayment dates added for TLTRO repayment
  - Signal start of discussion on QT
- Dec 15th 2022: QT announced with APP re-investment to reduce from end of February 2023 by an average 15bn/mth until end of Q2 2023
  - Dec repayment of TLTRO
- Feb 7th 2023: European Government deposits ceiling at €STR -20bp from April 30th. Level of ESTER-20bp to evolve with QT?
III - AN IMPROVED SITUATION: German Specials

- Improvement in Repo conditions after a peak stress at Sep quarter end
- German Finance agency decision anticipated (?) or validating the post end of Q3 levels
- Turn of the year repo level realised ~ -2%, much improved from <-5% expected level in October
- Back to “normal”/ pre-squeeze levels at end of January

*BKO went to -500bp
III - AN IMPROVED SITUATION: German spreads against swap

- Real improvement of both Repo and bonds pricing against swaps started after Sep. quarter end, slightly before TLTRO change and 54bn German DMO own holdings increase
- Improved sentiment on risky assets also allowed a reduction positions from leveraged accounts
- TLTRO repayment, end of QE and more particularly QT start announcement in December helped even more
- Going through year end helped materialise the improved sentiment
- Expected increase in German spending , and corresponding Q1 2023 supply also strongly contributed
- Still going into Jan. ECB fast money played a widening of the Asset swap anticipating no action of ECB on Gov. deposits

* yield-yield spread between the forward CTD bond and the matching maturity forward swap

- TLTRO conditions change
- Increase in available DE bonds by DMO
- European Gov deposits announcement
IV - IMPACT OF ECB ANNOUNCEMENT ON GOV. DEPOSITS ON EUROPEAN T-BILLS

- Evolution of the 6mth French and German bills swap spread since Jan 2022
- Spread moves for France and Germany bills on the day of the announcement

*spread = yield-yield spread bill vs matching maturity ESTR swap

Spread to ESTR (bp): impact post Feb announcement
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