

ECB MMCG – 7 Dec 2022

Market reaction to 27 October ECB, outlook + short term and 2022 year-end expectations

December 2022



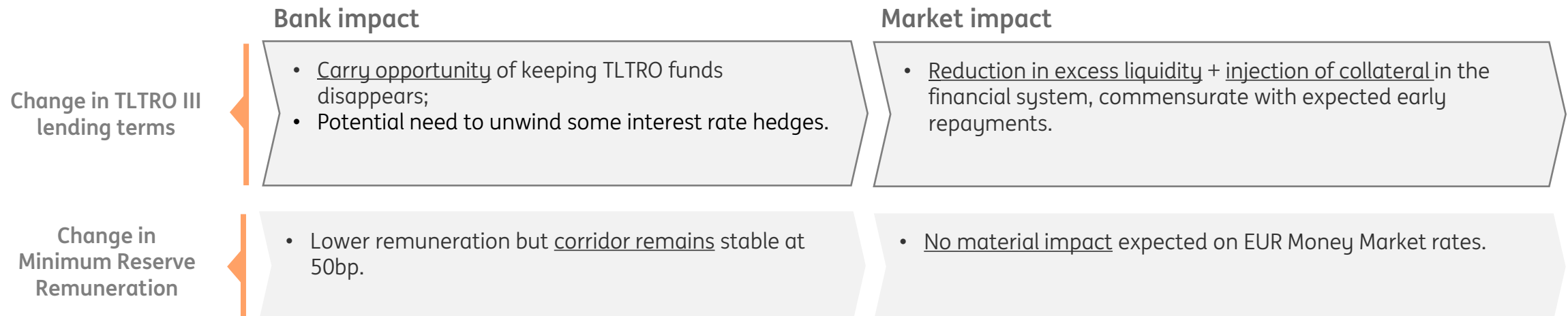
do your thing

Agenda

1. 27 October meeting – Market Absorption + High Level Impact
2. TLTRO III Pricing Changes – Implications (bank + market)
3. TLTRO III Outstandings and Prepayment Outlook
4. Excess Liquidity Reduction – Swap Spreads
5. 2022 Year-End Impact – FX Swaps

1) 27 October ECB meeting – Market Absorption + High Level Impact

- The 75bp rate hike on October 27th was the consensus expectation for markets;
- Contrary to the lagged transmission in aftermath of the September 75bp rate hike, which took market somewhat by surprise, the transmission to EUR Money Markets following the October 27th 75bp rate hike was more instant. Only slight lag in EURIBOR levels, **near immediate transmission** in repo levels compared to September;
- The extended policy-tightening stance brought forward with the two announced measures (TLTRO + MRR), is expected to have an impact on EUR Money Markets, albeit **subdued in the short term**;
- We do believe that whereas both measures are important changes to the further monetary policy transmission to EUR Money Markets, they are probably the two options with the lowest risk of disruption to market functioning.



2) TLTRO III Pricing Changes – Implications (bank)

- As per June 2022, under the increasing interest rate environment, the TLTRO III pricing mechanism created an open interest risk sensitivity for banks. To prevent a material interest rate risk exposure and to lock-in relatively cheap funding for the remaining maturity, some banks hedged this open position;
- However, change in the TLTRO III pricing mechanism results in hedge ineffectiveness and banks have to bear the **negative MtM positions** of the hedging instruments.

Main implications

P&L impact

- Recognition of the current MtM of the hedging derivatives offset by remaining positive accruals;
- Loss of future carry opportunity.

Capital impact

- Based on the P&L implications, we do expect a moderate impact on CET1.

Repayment strategy

- Repayment strategy aligned with banks' funding plan, increasing the need for CD/CP and LT debt issuance.

Other consequences

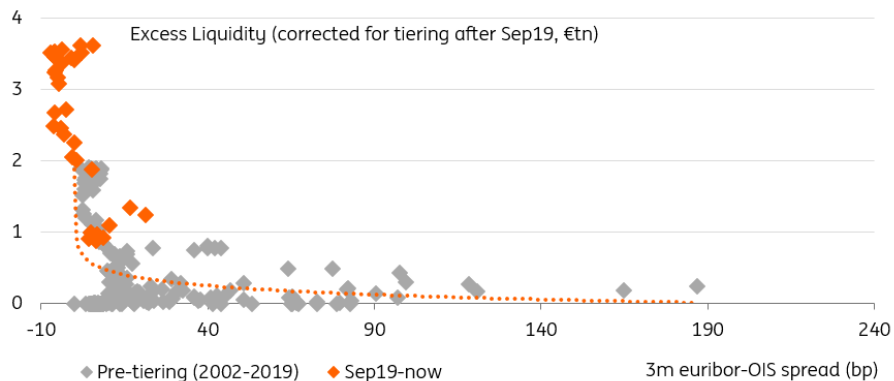
- Loss of credibility;
- Uncertainty around future monetary operations.

2) TLTRO III Pricing Changes – Implications (market)

- Although changes to TLTRO pricing is expected to cause less disruption to Money Markets compared to other alternatives (e.g. various tiering options), we do expect **early repayments** will lead to:

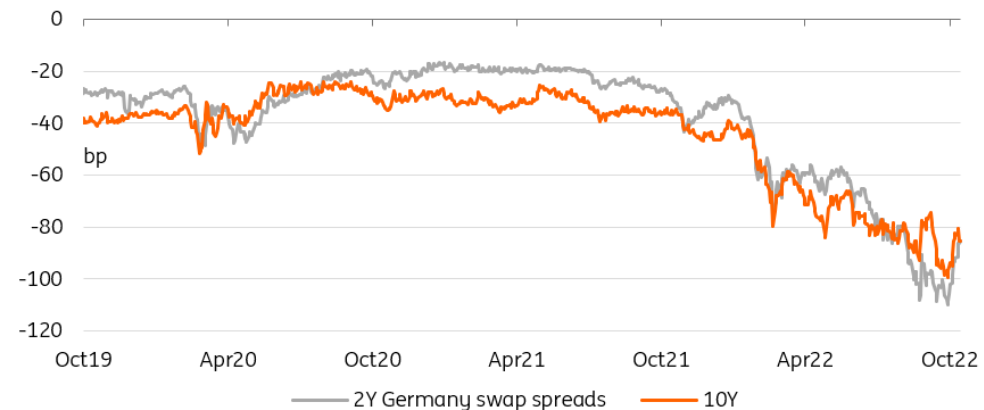
A commensurate reduction in excess liquidity

- No immediate jump in Money Market rates is expected given the amount of excess liquidity still in the system;
- We do expect it will make excess liquidity more sensitive to other factors, in particular credit risk;
- We would expect a widening of the 3m EURIBOR-ESTR basis and ESTR rising relative to the deposit rate, over time.



An injection of collateral in the financial system

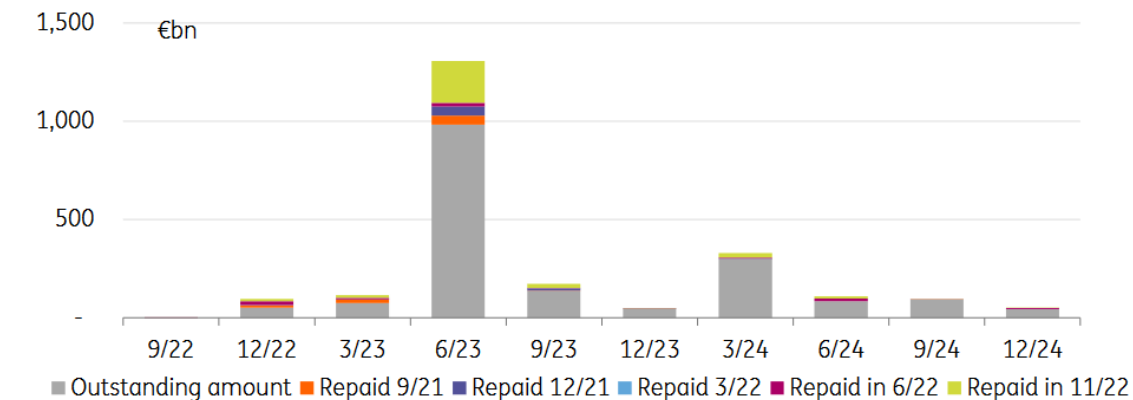
- Release of collateral would help with the current shortage, albeit this likely will have a limited impact, given the potential amount of high quality collateral (like German bunds) injected back in the system;
- However, on aggregate less excess liquidity chasing the same high-quality collateral should be a relief for markets;
- We think the new TLTRO terms should assist the already sizeable tightening of swap spreads.



3) TLTRO III Outstandings and Prepayment Outlook

- Overall we see that banks chose to **remain cautious** and retain their elevated liquidity buffers for now, repaying less than EUR 300bn of their TLTRO III balances in November, after the change of the terms of the programme;
- This leaves c. EUR 1.8trn of outstanding TLTRO balances and we believe that many larger banks have continued holding on to the bulk of their TLTRO balances for now and over 2022 year-end as a precautionary measure.

TLTRO-III programme: outstanding balances vs early repayments



Source: ING, ECB

Prepayment outlook

- The bulk of the TLTRO III programme matures over the course of 2023 with a still significant EUR 1,059bn in 1H2023 and a further EUR 184bn in 2H2023;
- We estimate that banks could seek to pay down **some EUR 100bn-300bn in December 2022**. However, due to the smaller-than-expected November repayment, December repayments may now be higher nonetheless;
- We believe banks will use their elevated liquidity buffers to pay down the TLTRO III drawings.

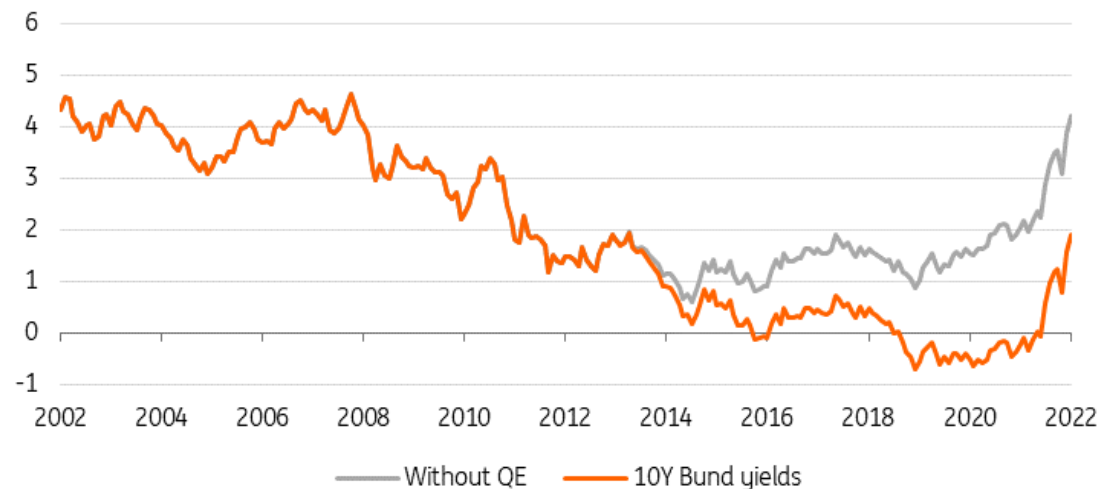
4) Excess Liquidity Reduction – Swap Spreads

Short term expectation

- For **2022 year-end**, we do not expect any material impact on swap spreads due to the amount of excess liquidity still in the system, even taking into account the expected TLTRO III repayments in December. As mentioned, a possible injection of collateral in the market may have some further tightening effect on swap spreads;
- **FRA-ESTR spreads** have been stable and we do not foresee any notable changes there towards year-end;
- Currently the expected TLTRO III repayments do not seem problematic for the market to absorb in the short term.

Long term outlook

- We expect **greater competition for liquidity** in the future, delivering a second wave of financial tightening;
- The start of Eurozone QT discussions, with possible phasing out of APP reinvestments, will add to these pressures;
- The impact on long-end rates should be limited at the start, but QE has suppressed yields by more than 200bp. Hence, the real long term risk is for **sovereign spreads**.



5) 2022 Year-End impact – FX Swaps

- **2022 year-end** FX swaps trading at elevated levels of between 12% and 15% implied for USD, for the 4-day year-end turn;

Main driver

-
- EUR collateral scarcity is driving EUR repo levels down;
 - Counterparties in EUR/USD FX swaps (US banks selling USD, buying EUR), have to partly or fully park the EUR funds at the lower repo levels;
 - This difference is priced in FX swaps currently, pushing the basis wider.

- Expected TLTRO III repayments in December, with commensurate reduction of excess liquidity and injection of collateral in the financial system, is expected to provide some **relief to EUR repo markets**, and dampen the current elevated year-end EUR/USD FX swap levels as a result.



do your thing