

Demand for central bank reserves

Money Market Contact Group

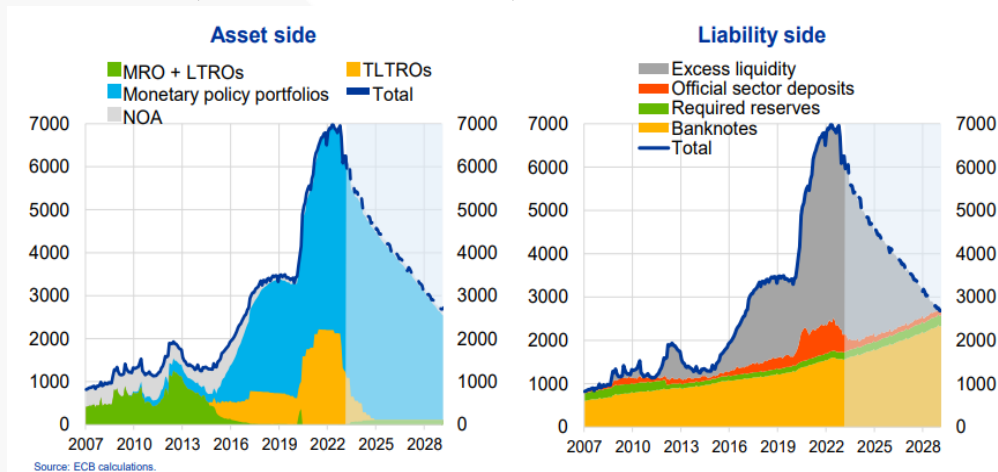
14th March 2024



HSBC

2024 Liquidity Outlook: Slow tightening

Eurosystem balance sheet: actual and projected (EUR bn) – source: ECB



◆ Reduction in excess reserves is expected to be limited in 2024...

The pace of reduction of Asset Purchase Programme (APP estimated monthly 28bn EUR) and Pandemic Emergency Purchase Programme (PEPP monthly 7.5bn EUR from July 24) and end of Targeted Long-Term Refinancing Operations (TLTRO for 393bn EUR left) will only gradually change the liquidity volumes in the Eurosystem

◆ ... but the pace could be impacted further down the line

As QE unwinds, the ECB must consider the role of reserves in safeguarding micro- and macro-prudential stability amidst evolving risks. The ECB's Operational framework review to be delivered before the summer will prefigure the future reserve regime.

Which factors influence banks' demand for central bank reserves ?

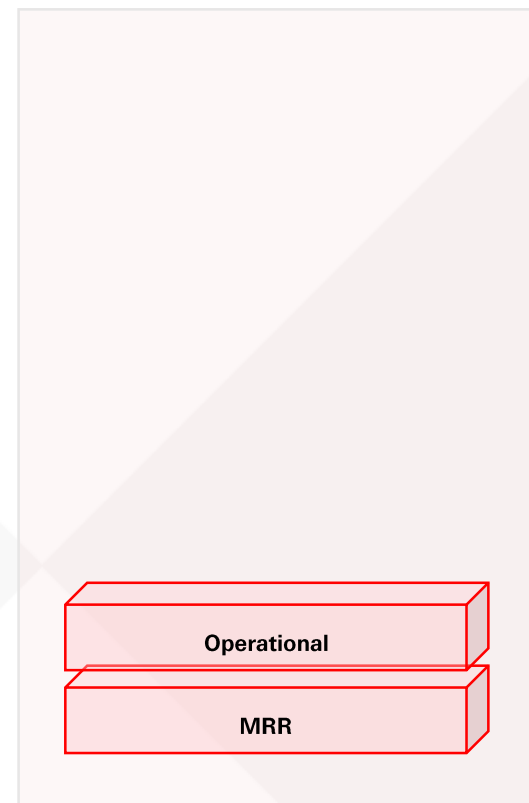
Banks' demand for central bank reserves...

- ◆ ... to meet mandatory reserves requirement (MRR)
- ◆ ... to meet known or predictable operational outflows

- ✓ Working capital requirement,
- ✓ Prefunding in payment and settlement system,
- ✓ Intraday liquidity to settle high value payments

Since the loss of confidence in the interbank market in 2007/2008 and the subsequent unfavourable regulatory treatment of the interbank deposits, the interbank market is effectively dead.

Banks' HQLA Holdings



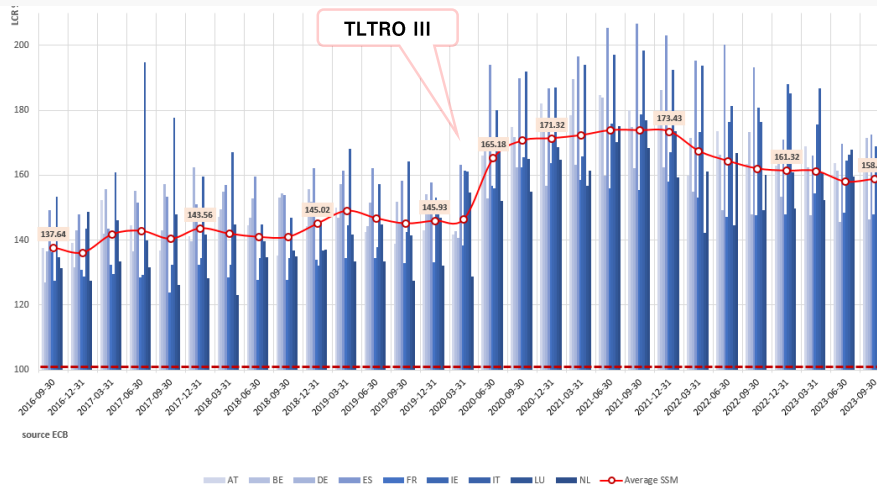
Banks' demand for central bank reserves...

◆ ... to meet liquidity requirements

For compliance with regulatory requirements (LCR) banks are required to hold a certain proportion of High-Quality Liquid Assets (HQLA) to cover outflows.

The composition of HQLA between securities and 'excess reserves' is driven by several liquidity and market-related factors

LCR by country & average LCR for SSM countries – source: ECB



Banks' HQLA Holdings



Banks' demand for central bank reserves ...

◆ ... to meet liquidity requirements

LCR is not in itself prescriptive on the excess reserves vs. securities constitution of the HQLA.

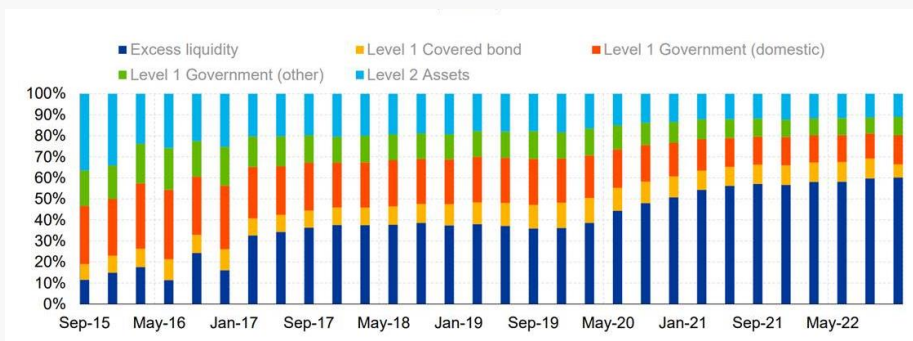
Cross-jurisdiction regulation and some Internal Liquidity Metrics can add up to LCR outflows and involve more specific HQLA buffer requirements.

This leads banks to maintain a certain portion of central bank reserves (vs L1 & L2 assets) in the allocation of their HQLA holdings.

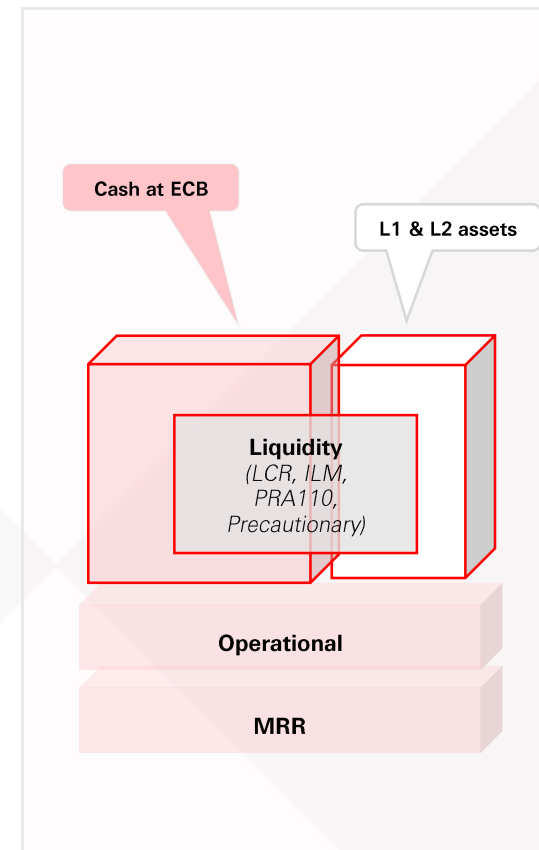
*For example **PRA110 report**: Monetization assumptions imply additional and timed outflows over LCR and favour the liquidity treatment of reserves as compared to non-reserve HQLA.*

The reserves dominance (60% at end of 2023) in HQLA portfolios is partly a result of regulatory / internal risk management schemes rather than purely strategic asset allocation decisions

High quality liquid assets (HQLA) held by euro area bank (% of total) – source: ECB



Banks' HQLA Holdings



Banks' demand for central bank reserves ...

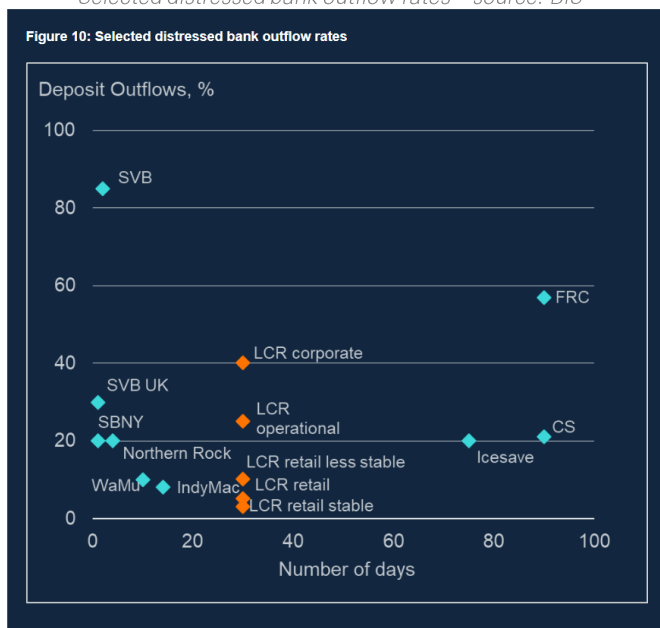
◆ ... to meet liquidity requirements

The idiosyncratic liquidity risk is managed via the banks' risk appetite considering factors like stress-testing, volatility, and specificities of the business model.

The vulnerabilities faced by banks, such as reputational risks and deposit outflows further underscore the importance of holding precautionary reserves, especially in an increasingly digitalized banking landscape (ex: SVB)

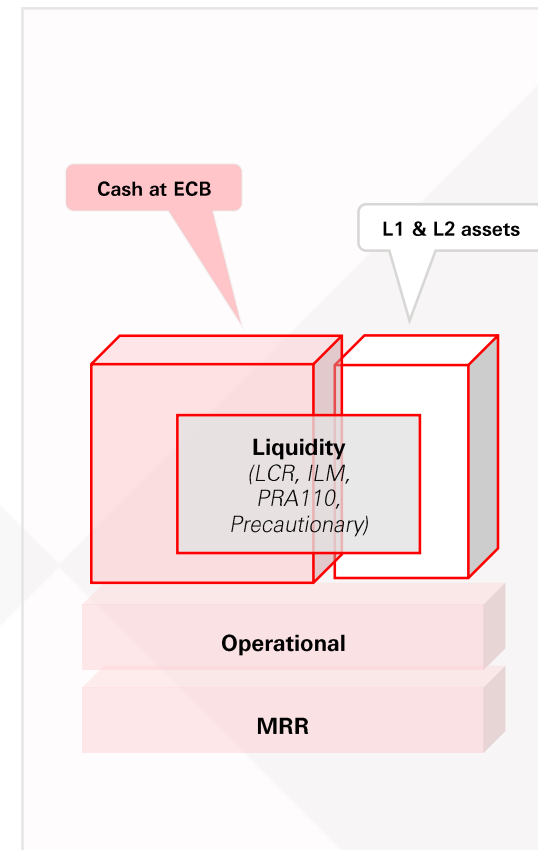
Time horizon of **monetizability** is a key consideration for prudential cash requirement.

Selected distressed bank outflow rates – source: BIS



Source: Bank for International Settlements Report on the 2023 banking turmoil (bis.org)

Banks' HQLA Holdings



Banks' demand for central bank reserves ...

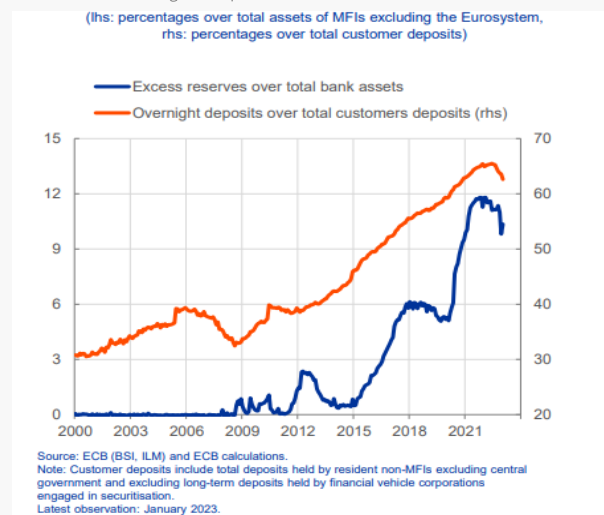
◆ ... as an opportunistic option

The reserves demand depends on their rate of return relative to other safe and liquid assets

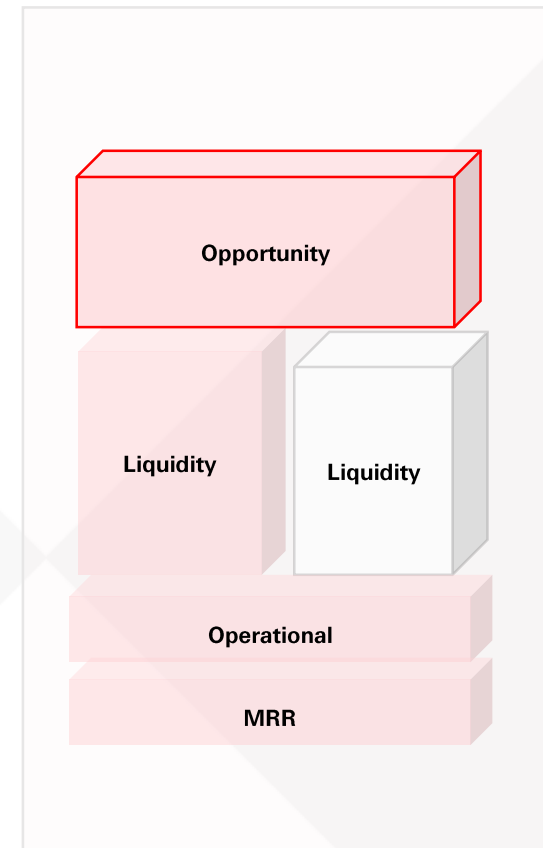
✓ Unsecured market between bank and non-banks

Under constraints of LCR and Leverage ratio, the banks accept to channel clients' - notably NBFI - liquidity excesses back to ECB, with notable associated balance sheet costs, reflected in the current ESTR / DFR spread.

Euro area overnight deposits and excess reserves – source: ECB



Banks' HQLA Holdings



Banks' demand for central bank reserves ...

◆ ... as an opportunistic option

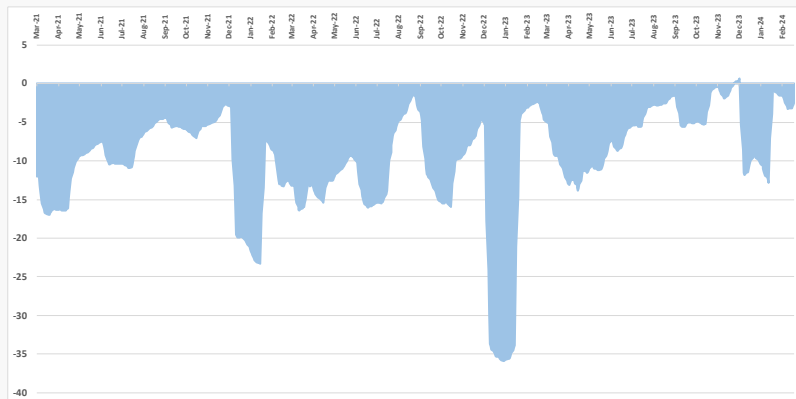
✓ Crossborder reserves and cross-currency basis

FX swap and XCCY markets are a reflexion of the cross liquidity appetite across two currencies.

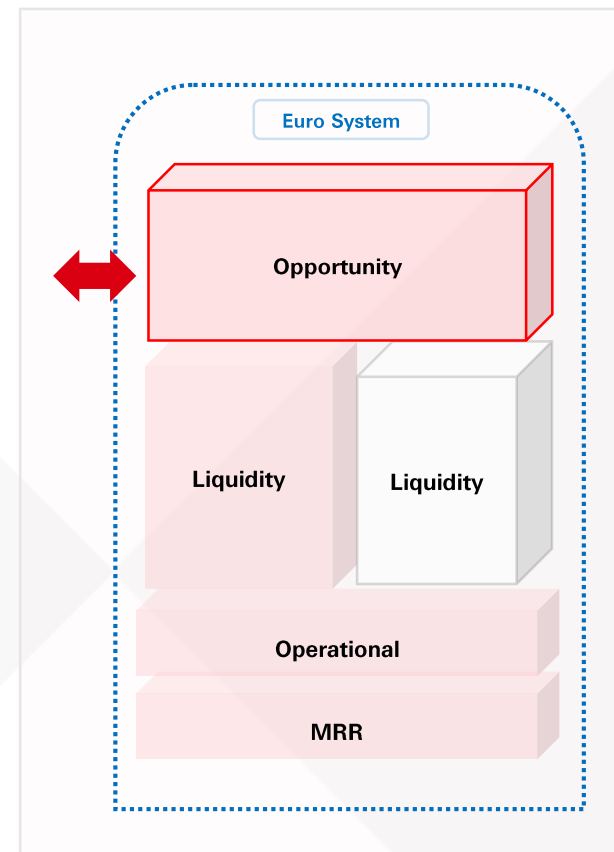
Certain institutions maintain access to different reserves under different jurisdictions (eg. BoE / ECB). These can dynamically adapt their own reserves demand based on local markets and monetary conditions.

Since the decision to set the remuneration of MRR at 0%, it has been noticeable that Month-ends for which deposits are accounted for in reserves calculation show deeper volatility on the FX swap market with lower interest for EUR reserves on these dates

1W EURUSD FX implied vs. ESTR swap spread (30d average in bp) – source: Bloomberg



Banks' HQLA Holdings



Banks' demand for central bank reserves ...

◆ ... as an opportunistic option

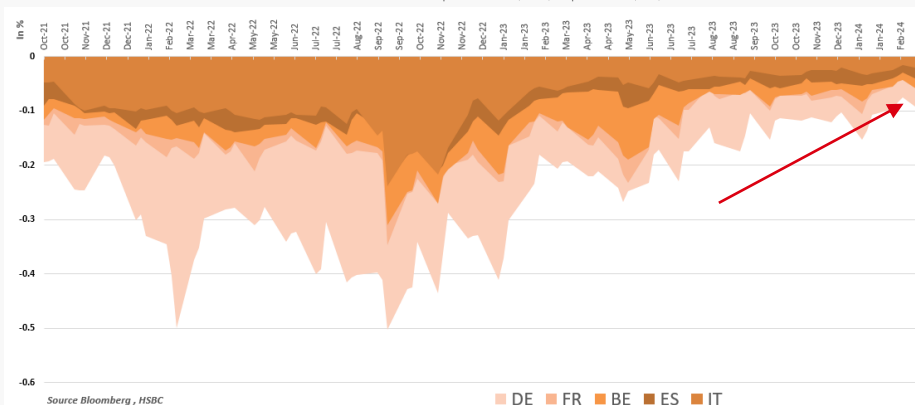
The reserves demand depends on their rate of return relative to other safe and liquid assets

✓ GC repo rate / DFR spread

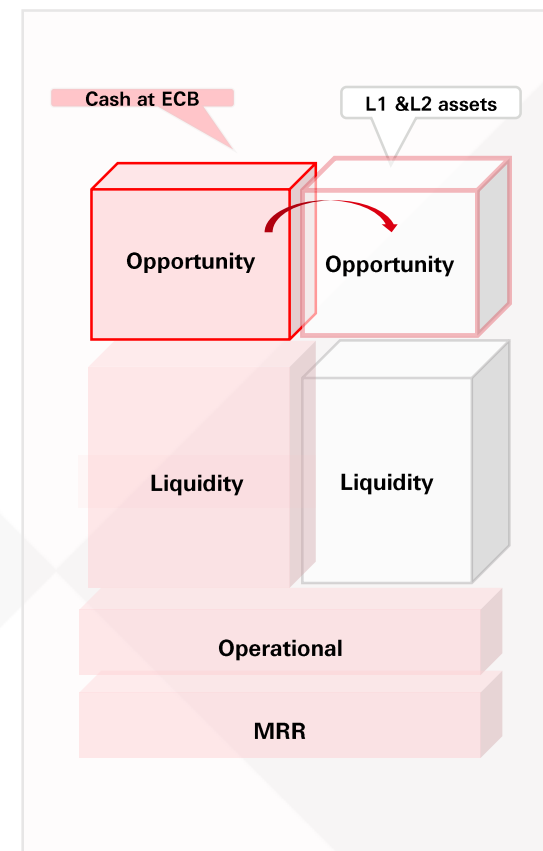
In a collateral scarcity regime - induced by QE - the core HQLA L1 & L2 can be substituted by reserves through secured market with the benefit of the GC repo rate / DFR spread.

While the reduction of the APP has started this rebalancing could be fading away.

European Government Bonds General Collateral repo rate (t/n) spread (%) vs DFR – source: Bloomberg



Banks' HQLA Holdings



Banks' demand for central bank reserves ...

◆ ... as an opportunistic option **under constraints**

While the QT and large supply are expected to cheapen the price of the non-reserve HQLA, the substitution effect from reserves to bond purchase is capped by:

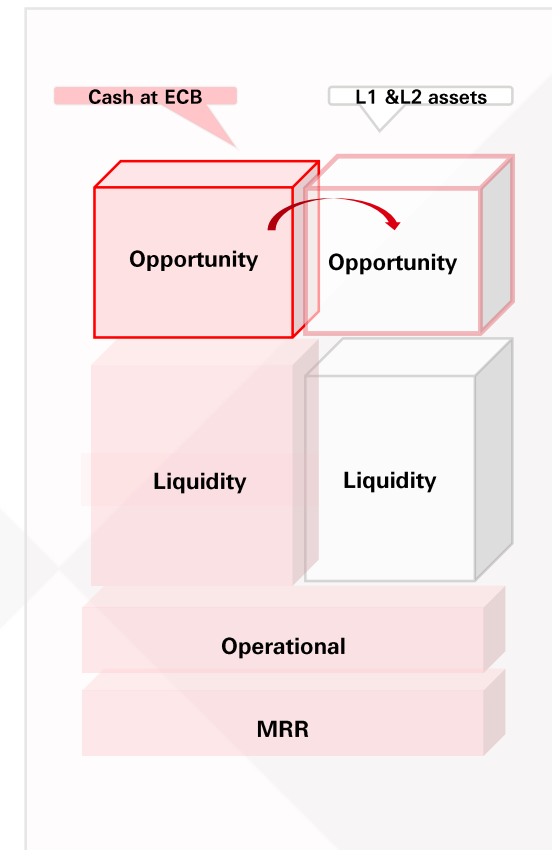
✓ **Accounting volatility:**

Capital requirement is affected by HTC&S portfolio mark-to-market through the Other Comprehensive Income (OCI) driving volatility in the accounts.

✓ **Risk appetite to credit spread**

Internal economic capital modelling appetite to run credit spread risk limits deployment capacities.

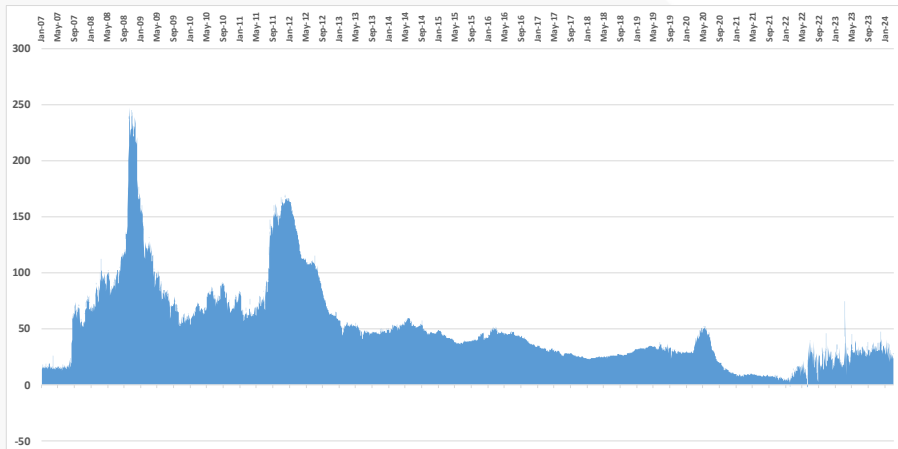
Banks' HQLA Holdings



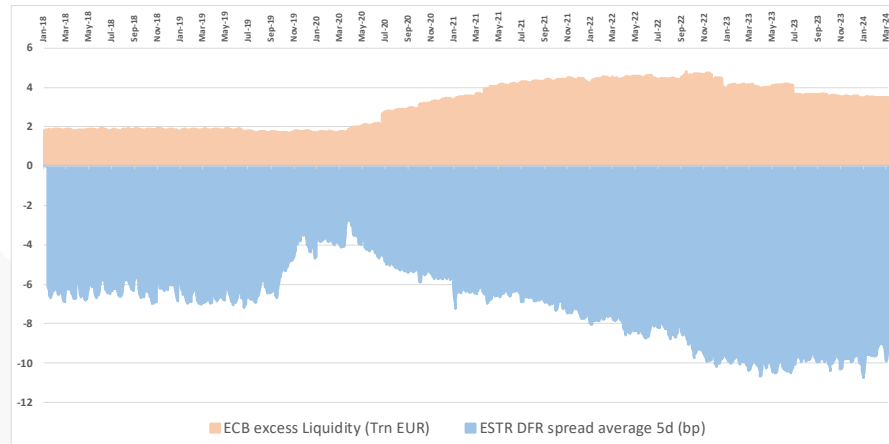
When will these factors start to become binding and which metrics will first reflect tightening liquidity conditions?

Liquidity sourcing fading away

E12M ESTR1Y swap spread (bp)– source: Bloomberg



ESTR DFR spread vs. Excess Liquidity – source: Bloomberg



◆ Tightening likely to be anticipated in EURIBOR / ESTR spread

The spread between term Euribor and ESTR Swaps materialises the forecasted conditions on the unsecured FI markets from panel banks to compensate for a reduced liquidity. It is considered more meaningful than ESTR – DFR spread as, if banks compete for liquidity they would rather secure it on term.

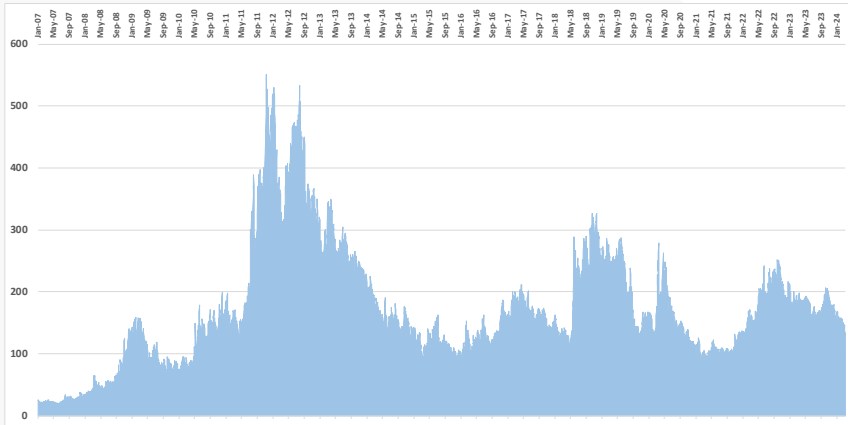
These effects would outline two antagonist effect: increasing need for reserves due to shortage, and reduced incentive to raise excess cash.

◆ ESTR / DFR spread as a late indicator

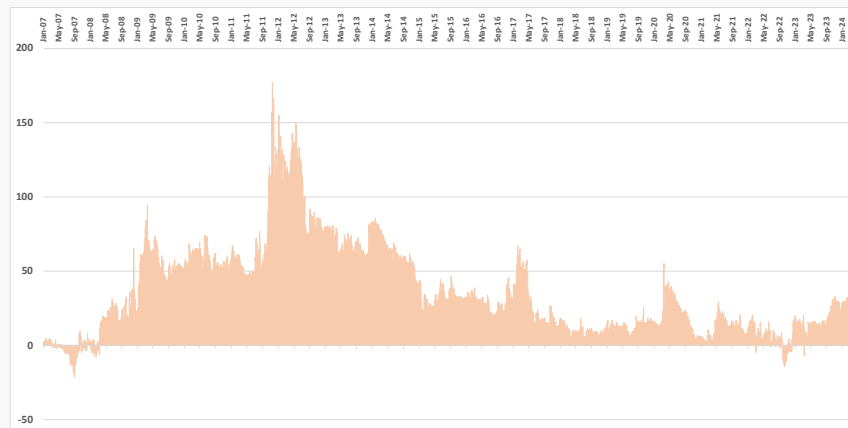
The ESTR / DFR spread has historically been quite stable around (below) the ECB deposit facility rate. Market expects that the excess reserves would have to drop below 1 trillion EUR for ESTR to switch above DFR. This is therefore likely to kick in late – if ever – in the tightening process depending on the outcome of the ECB operational framework review.

Wider spectrum of Investment Opportunities

BTP – BUND 10Y spread (bp) – source: Bloomberg



10Y OAT ESTR swap spread (bp) – source: Bloomberg



◆ Sovereign spreads differentiation

The gradual reduction of liquidity in the Eurosystem via purchases programmes would likely revive spreads tensions between Eurozone individual government bonds.

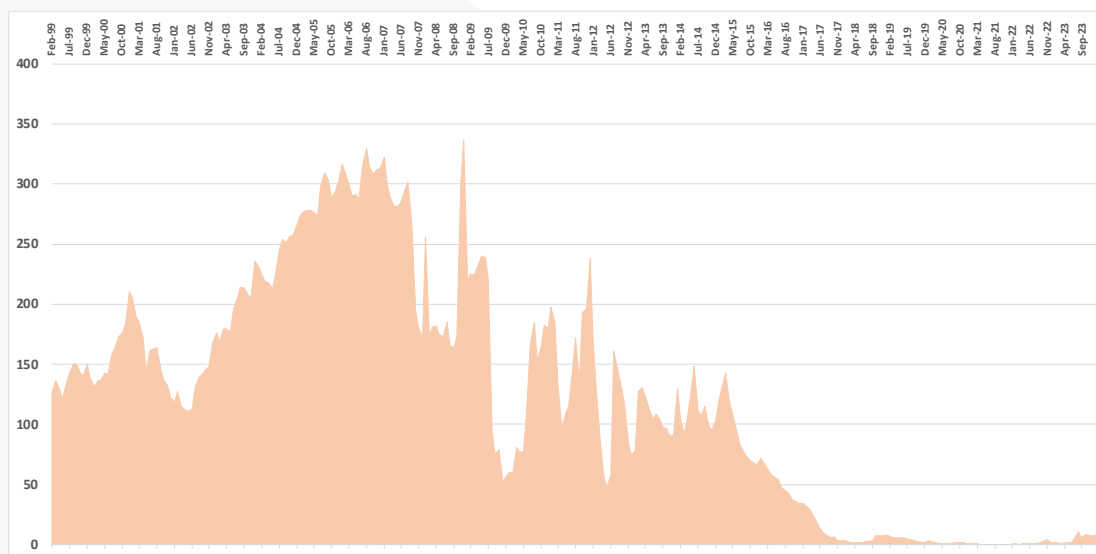
This is likely to be even more the case should GC government bond collateral cheapen as a whole on the secured market.

◆ Asset Swap Spreads cheapening

With less direct and indirect (through Banks funding) investment into the Bonds market by the ECB, and a more prudent approach to Treasury Management, the Eurozone L1 HQLA ASW spreads are likely to cheapen. This could trigger an antagonist incentive for banks to take the opportunity to lock in margins on their residual treasury.

Central Bank Facilities from Backstop to Standard

MRO Usage by Eurozone Banks (EURbn) – source: Bloomberg



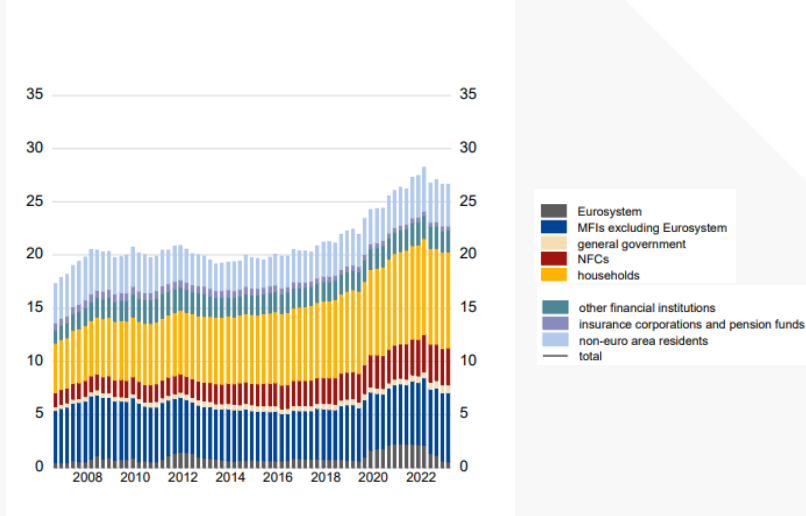
◆ Expected increase in MRO / LTRO use by Banks

By definition, scarcer liquidity in the Eurosystem would trigger stronger interest for central bank refinancing operations, including MRO and LTRO.

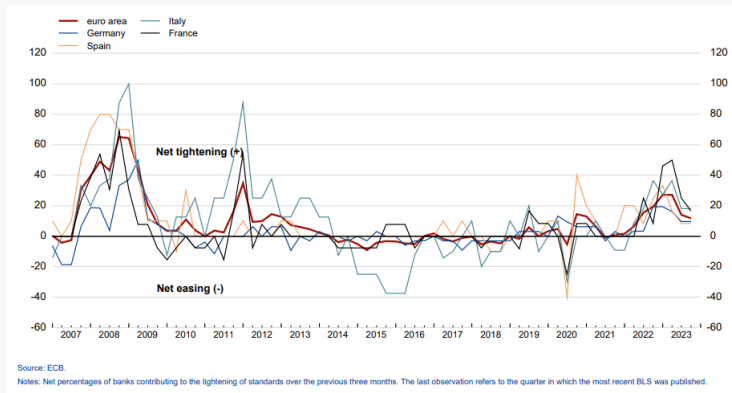
Historically when excess liquidity was narrower in the Eurozone, the usage of the MRO was occasionally much more meaningful than currently.

Banks Balance Sheets: The great change?

MFI's Funding Outstanding Amount (EURbn) – source: ECB



Changes in credit standards for loans to Corporates (EURbn) – source: ECB



◆ Funding Structure

Banks' liquidity sources vary quite materially depending on economic and regulatory context.

With the reduction of Central Bank participation to banks' liabilities, a reshuffle of the funding mix is likely to materialise – with a potential revival of interbank unsecured market flows.

◆ Credit Tightening

Tightening triggers a contraction of credit conditions to households and non-financial corporates. As the cost of liquidity rises, the credit conditions tighten.

On the basis of larger refinancing costs channeled to the real economy, the number of defaults and failures could increase as well.

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Funds with a single sector focus will typically be more volatile than funds which invest broadly across markets. Funds with a single country focus will typically be more volatile than funds which invest broadly across markets and geographies.

Region-specific funds have a limited investment scope and are susceptible to a decline in the region in which they invest. Therefore, these funds may be more risky than those which invest more broadly across markets and geographies.

Countries where political leadership is either unstable or where it exerts a very strong influence on markets and business practices may be subject to greater volatility. Political risk may include potential for currency controls which would disrupt efficient financial markets.

Limited transparency is typically a feature of both hedge funds and funds of funds. Funds of funds rely on underlying managers' allocations and holdings may be less transparent than in single manager long-only funds. Furthermore, hedge funds in particular may have highly tactical investments along with less frequent and less stringent reporting requirements which does not provide investors with a picture of holdings on any given day.

Currency may have either a direct or indirect effect on individuals' investments. Where the reference currency is different from the reporting currency, foreign exchange movements will directly impact the value of the holdings. Currency will indirectly impact the value of the underlying investments as foreign exchange movements strongly influence the market economy and the competitiveness of both domestic and international companies. Funds which try to hedge to a reference currency can mitigate the direct impact of currency movements but cannot completely isolate the indirect effects of foreign exchange movements.

