Choice of HQLA buffer composition and impact on money market

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Items for consideration

- How has the HQLA composition evolved over the past years and how is it expected to proceed in the future.

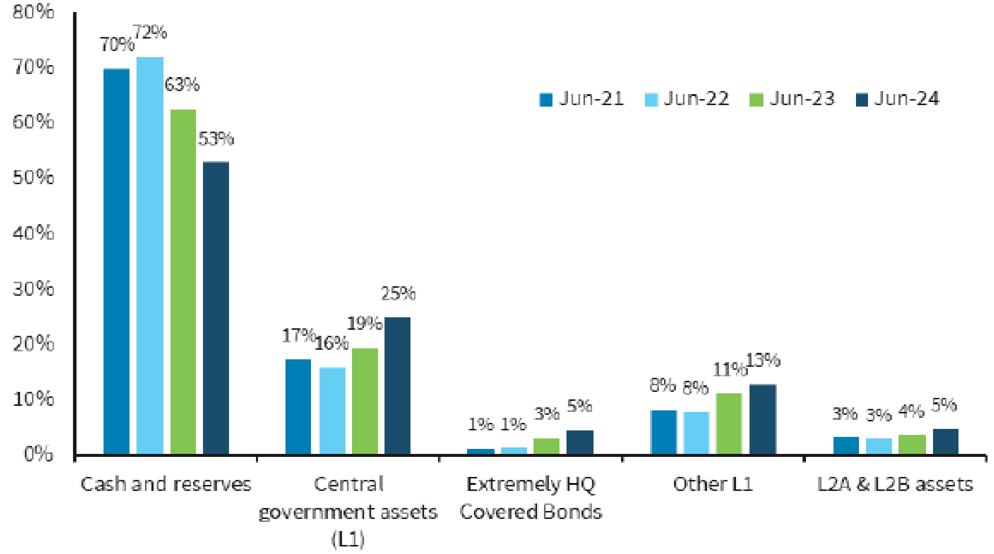
- What are the main factors determining this choice.

- Have the events of March 2023 affected the choice composition of HQLA buffers.

- What are the market functioning implications of the choice between reserves and securities and its expected evolution? Is there a preference on year-ends to show a higher share of reserves in the HQLA portfolio?

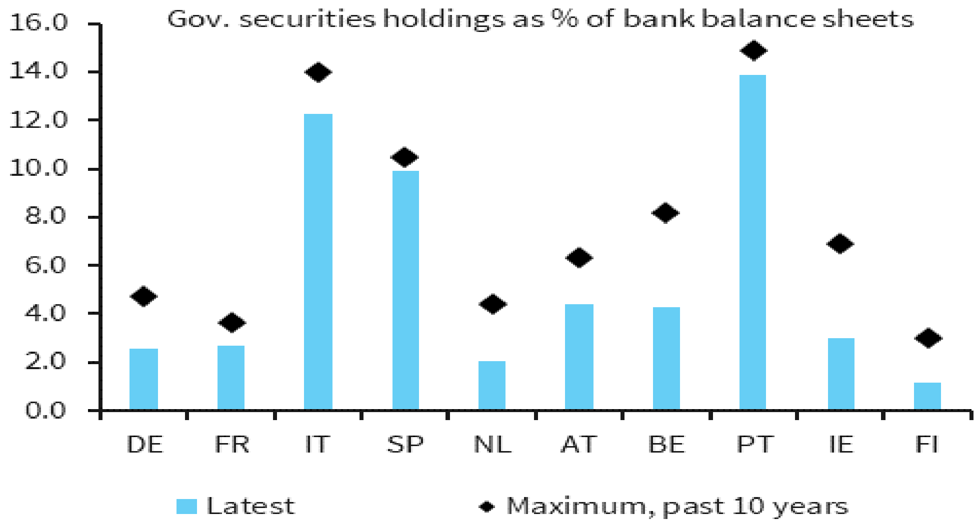
Evolution of HQLA composition 2021-2024

Banks have been rotating out of cash and reserves into other HQLA, primarily sovereign bonds



Source: EBA, ECB, Bloomberg, Barclays Research

Government bond holdings as a share of MFI (Monetary Financial Institutions)



Source: ECB, Bloomberg, Barclays Research

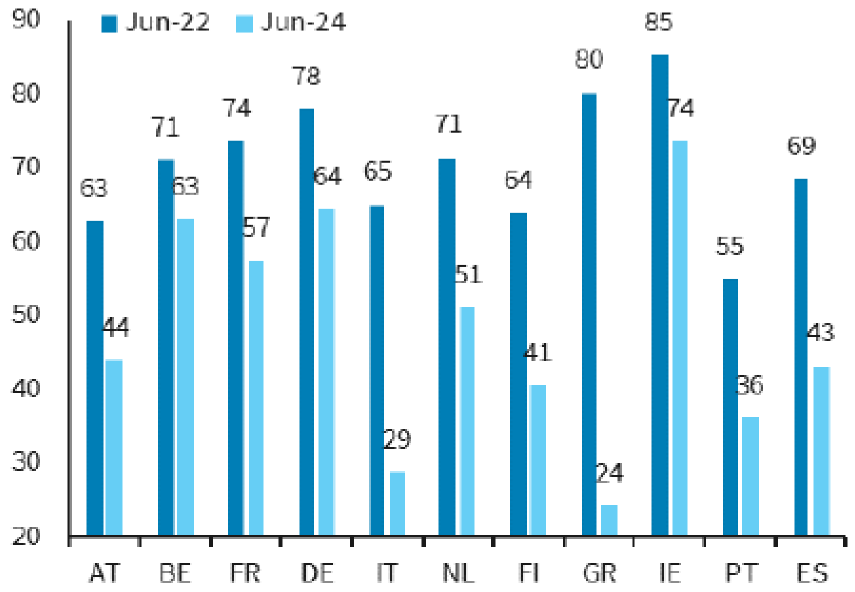
- There has been a steady rotation away from cash and reserves into central government assets and other HQLA over the past two years
- A key question going forward will be to what extent banks want to increase their sovereign exposures as a % of HQLA
- Increased volatility in swap spreads may generate capital volatility which could limit banks taking down further issuance.

- A rotation away from cash and reserves and into central government assets and other HQLA makes sense given that:

  1. Banks remain well funded across various jurisdictions
  2. The loan to deposit ratio is below 100, leaving banks with excess cash which could be deployed into Government Bonds
  3. The pick-up in EGBs is attractive
  4. Government Bond holdings as a % of MFI assets is below their historical peak

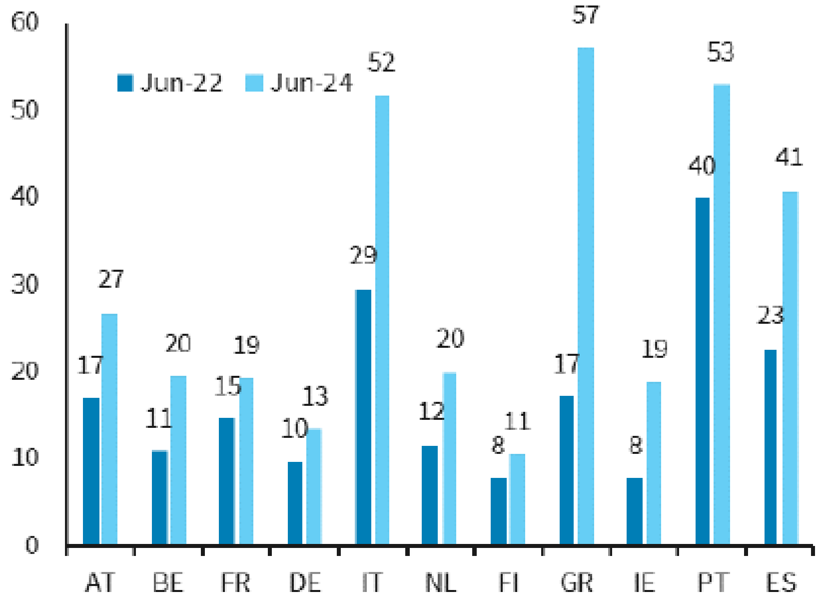
HQLA composition at a national level

Share of cash and reserves in HQLA mix



Source: EBA, Barclays Research

Share of central government assets in HQLA mix

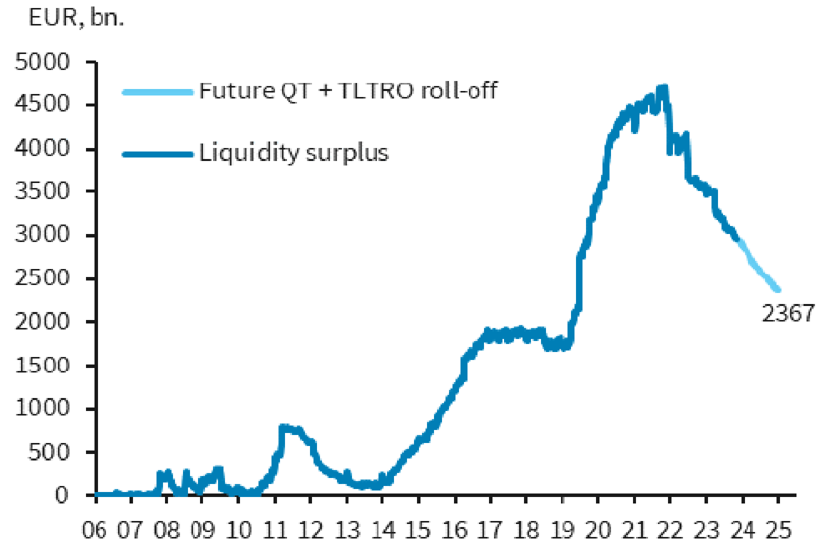


Source: EBA, Barclays Research

- The geographical split of banks' HQLA mix could be important, for example, in Italy, Greece and Portugal, the share of central government assets in HQLA is already > 50%. Ireland, Belgium and Germany have the greatest share of cash and reserves in the HQLA mix.
- The question remains as to how far the rotation from Cash and Reserves into central government bonds can go, and whether there are % floor levels overall and within specific countries.

Liquidity in the Euro area

Excess liquidity is expected to decline below €2.5trn next year on QT and TLTRO roll-off

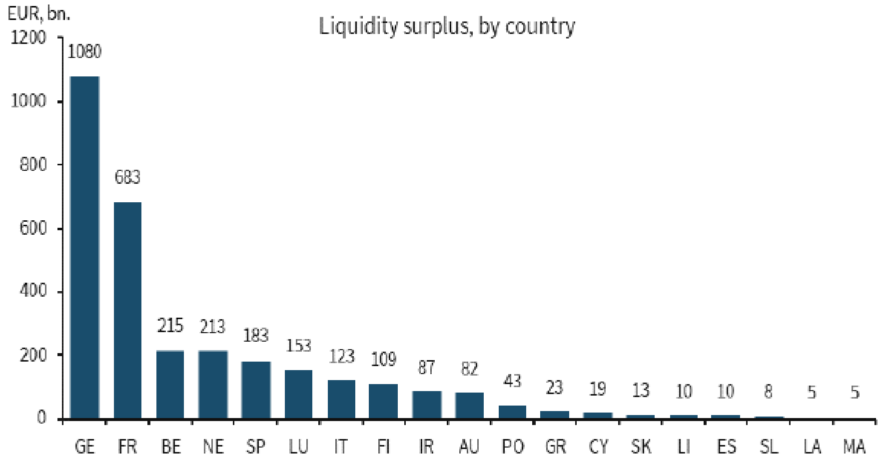


- Excess liquidity in the Eurosystem has declined from €4.7trn in 2022 to circa €3trn today. Excess liquidity is expected to decline to €2.3trn by the end of 2025. However the scale of the decline will be determined by the evolution of autonomous factors (government and non-resident deposits with the Eurosystem) and borrowing at the ECB's operations.

- As excess liquidity has declined, the overall concentration of excess liquidity has not changed much with Germany and France still sharing c.55-60% between them.

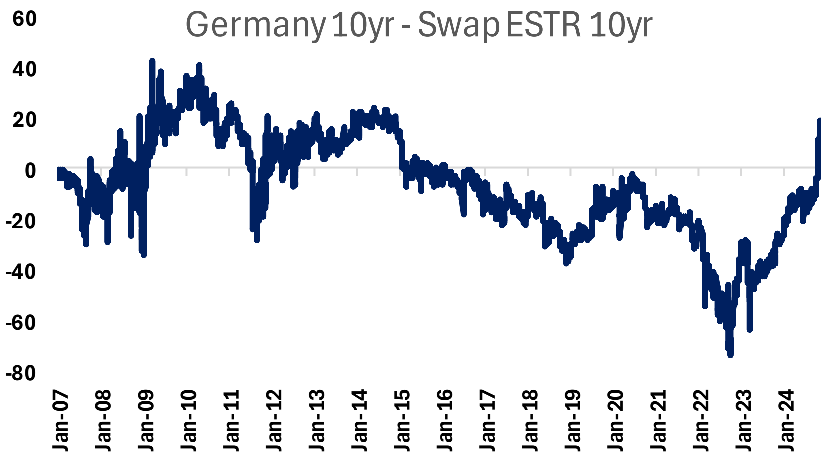
- The improved attractiveness of EGB ASW spreads along with other HQLA spreads has been a large driver of this rotation

Excess liquidity distribution by country



Source for both charts: ECB, Haver analytics, Barclays Research

10Y Bund Asset Swap vs ESTR (basis points)

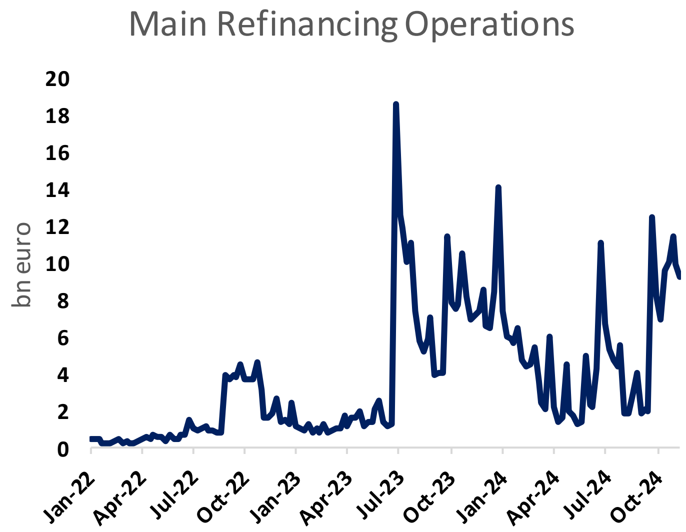


LCR and demand for reserves

Is there a minimum for cash & reserves, as % of total HQLA?

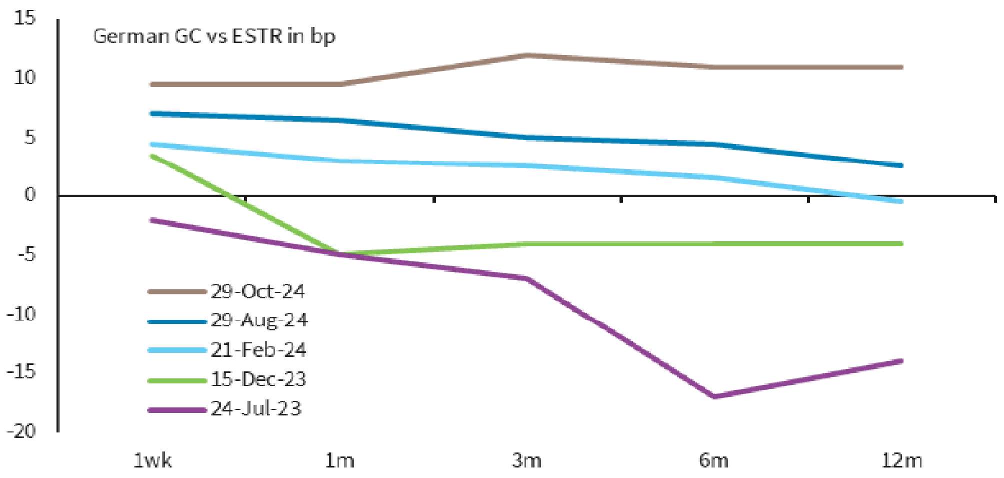
- As of Jun-24 (EBA reporting) 53% of HQLA is cash and reserves. LCR levels are around 160%.
- Key factors for the future evolution of reserves held by banks:
  - Preference of cash reserves versus other forms of HQLA
  - Preference for a buffer vs the required LCR of 100%
- Falling excess liquidity will translate into lower reserves, lower HQLAs and lower LCRs. But banks will want to hold comfortable buffers, larger than in the past.

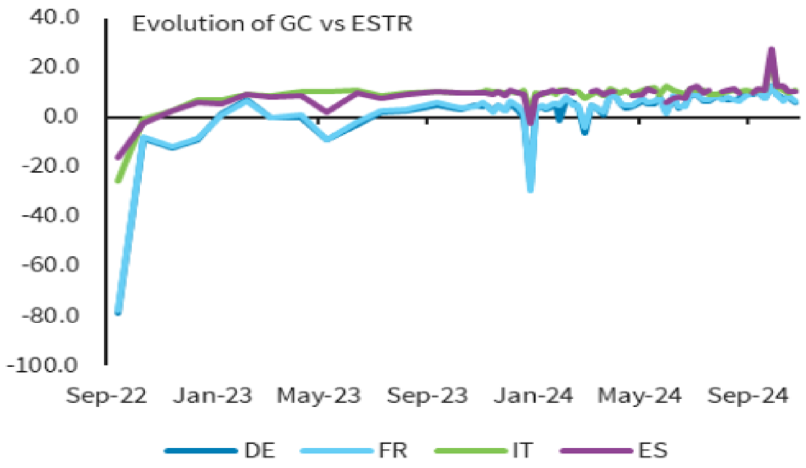
- Pricing of central bank facilities plays a role for the willingness of banks to use these facilities to borrow reserves.
- The narrowing of the corridor between MRO-DFR to 15bp has made the ECB's liquidity operations more attractive even though market sourced funding have generally been cheaper than the ECB's MRO. However, in recent weeks, repo rates have cheapened considerably.
- As things stand, the relatively low take-up in the 1wk MRO and 3m LTRO signals that the aggregate Eurosystem excess liquidity remains plentiful even though there is fragmentation across and within countries.
- But looking ahead, the decline of excess reserves will determine the volume borrowed at ECBs repo operations.



Price for reserves

Collateral has seen a general cheapening trend over the past months





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- To date there has been little impact from the decline in excess liquidity on unsecured money market rates. The ESTR vs Deposit Rate Spread averaged 10bp in 2023 and 9bp YTD 2024. Euribor 3mth vs 3mth ESTR spread averaged 0bp in 2023 and **6bp YTD 2024**.
- Volume issued in EUR CP has shown a steady decline since the ECB has accelerated its easing cycle.

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- Collateral has broadly cheapened over the past year, German GC Rates have moved broadly in line with the ECB Deposit Rate equivalents. This has had significant knock on impacts into ASW spreads. German 10Y ASW has cheapened by 25bp since mid September which has dragged the entire Euro Area Spread complex higher. GC is close to DFR (so 8.5bp above ESTR)
- The highest free float creation on record in Europe and ECB easing will increase demand for repo.
- Despite the optically high level of excess liquidity, banks balance sheet are constrained, especially for activities like repo (as a way to increase reserves)
- **Year-end :** MRO (due to narrowed corridor of only 15 bp) should provide a tool to adjust the level of LCR and % of reserves on reporting dates. It is, however, not clear that will be a backstop to repo rates on year end due to balance sheet constraints

2023: Stable HQLA composition; regulatory focus

- **HQLA composition in 2023:** The events of March 2023 have had **no discernible impact** on HQLA compositions.

- **Regulatory focus** (e.g. Basel Committee on Banking Supervision, Oct-2024): "The experience of the US banks during the March 2023 turmoil highlighted, however, that private repo markets may become a less reliable option for monetising securities held at AC for distressed banks during idiosyncratic liquidity stress scenarios. Moreover, in such scenarios the repo market itself may stop functioning smoothly, which suggests it could be highly procyclical and an unreliable source of contingent liquidity in severe idiosyncratic and market stress scenarios. This **raises questions as to whether HQLA held at AC can indeed be "repo-ed" through private markets in severe stress scenarios (particularly when such securities have substantial unrealised losses**). Under these specific circumstances, the central bank or other public sector counterparties may be the only viable monetisation channel for these assets, subject to haircuts applied by the central bank (which may not have been accounted for in the LCR-valuation, given the 0% haircut for Level 1 assets)."

- **No need to change regulatory treatment of HQLA**. Silicon Valley Bank (SVB) and Credit Suisse (CS) are idiosyncratic events, driven by concentrated deposit base (both) and repeated incidents (CS).

The 2023 banking turmoil and liquidity risk: a progress report (bis.org)

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