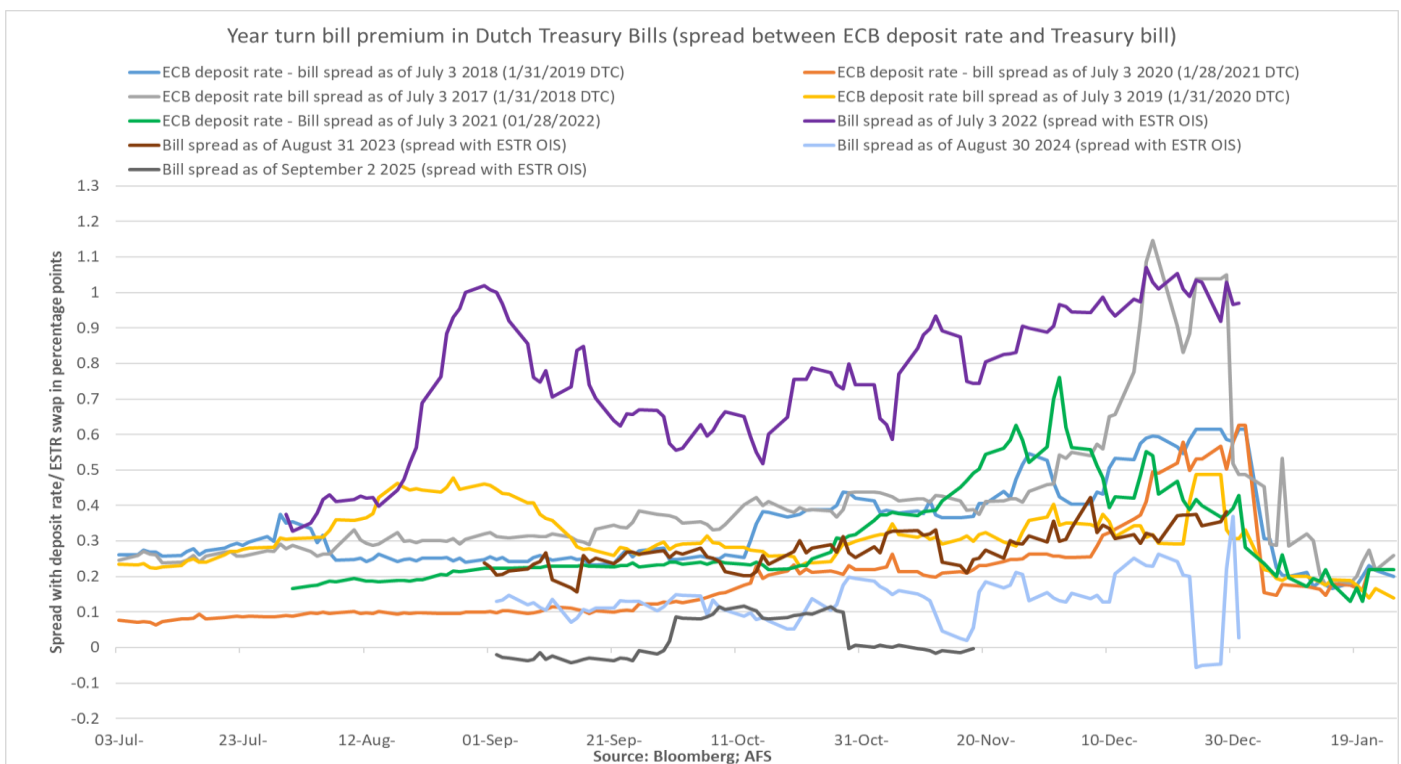


Research

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Back in the days...

- In the good old days, when interest rates were negative and when the ECB bought bonds by the bucketload, and with the year-end weeks away, anxious clients would routinely check us for levels on deposits that matured just past the turn. Remember, this was the time when interest rates on euro denominated deposits with a maturity in the first days or weeks of the new year could reach twenty percent or more. *Negative* twenty plus percent, mind you. Yeah, those were the days. The last two year turns have been relatively mild as measured by the premium on the Dutch Treasury bill that matures in January of the new year. According to Bloomberg prices, the highest premium on the Dutch Treasury bill that matures in late January over the constant maturity ESTR swap with the same date was 42bps during the 2023/2024 turn, down from a lofty 107bps during the 2022/2023 turn. Last year, we clocked the premium no higher than 37bps.
- The chart below shows the premium on the Dutch T-bill in bps over the constant maturity ESTR swap or the ECB deposit rate (when there were no rate hike or rate cut expectations):



- **At the time of writing, the Dutch T-bill trades ESTR flat.** What little premium there was at some point – 10bps – has evaporated. Based on an analysis of the factors that determine the severity of the turn, it is very unlikely that we will see a meaningful premium in the bill price. Or, generally speaking, there will be no bidding up on bills that mature just past the turn. Nor will there be a rush to place cash over the turn with ultra-safe counterparties: state treasuries, German promotional banks, etc. The turn will be easy, and that's because the culprit responsible for the dislocations – banks – have less need to window-dress their balance sheets and artificially boost their leverage ratios for their regulators, shareholders, and creditors.
- **In the days of yore, banks' balance sheets were bloated with unwanted wholesale deposits, the flipside of ECB money printing – ahem, I mean bond buying.** At the same time, interest rates were low or even negative, and the profitability of banks suffered duly. The banking system in its entirety cannot get rid of the unwanted assets (reserves with the central bank) and the corresponding unwanted liabilities (wholesale deposits). Furthermore, banks could charge wholesale depositors only so much in negative interest rates. Except when there was a reporting period, and even more so when that reporting period was the year turn. Borrowings over the turn had to boost the leverage ratio. Which is very hard to pull off because borrowing wholesale either decreases the leverage ratio (when the deposit was at another bank before) or maintains the leverage ratio at an undesirable low level (when the deposit is rolled over). To boost the leverage ratio, the interest the bank charged the depositor would have to be insanely high.
- **As put in this [excellent paper](#) but also mentioned in one or two reports from the Bank of International Settlements¹, the dislocations around the turn originate in the secured market.** And it goes like this. Outside reporting periods, Eurozone banks borrow *dollars* in the secured market. Since repo borrowing decreases the leverage ratio, and since the Eurozone banks really need those dollars, the banks turn to the FX swap market for dollars instead. FX swaps have the fortunate advantage that they are off-balance sheet. Meaning no effect on the leverage ratio. If that's too good to be true, it is. When Eurozone banks turn to the FX swap market *en masse* just when US banks also face a reporting period, the price moves. And not in a favorable way. Instead, the price literally goes out of whack and covered interest parity no longer even remotely applies. Dollar rates for tenors that mature just past the turn could be twenty percent or higher – the mirror image of negative euro rates. Furthermore, it goes without saying that banks would definitely not eat the loss on expensive off-balance sheet dollar borrowing. Instead, they would charge their hapless clients instead in the form of depressed interest rates.
- **Furthermore, and I know this from my own money market research, Eurozone banks are net borrowers of cash/reserves and suppliers of collateral in the Eurozone secured market.** Of course, the net borrowing position in the secured market has a negative effect on the leverage ratio. Ahead of the turn, banks simply retreat from the repo market. Wholesale depositors, who are on the other side of the trade, suddenly lose a venue to place cash securely. Like a swarm of locusts, the wholesale cash desperately tries to find riskless opportunities elsewhere. Since there simply aren't enough risk-free borrowers out there, these risk-free borrowers could name their price.

¹ See: https://www.bis.org/publ/qtrpdf/r_qt1912k.htm or <https://www.bis.org/bcbs/publ/wp42.pdf>

So, charging a depositor to place a punitive interest rate. Oh, and lest I forget, there was also a scarcity of high quality (read: German) collateral at the same time. Which would trade at insanely high prices (read: extremely negative interest rates).

- **Now, that's two pages on ancient money market history that no one cares about.** I haven't had anyone bring up the upcoming year turn. Yes, we see the usual dislocations – higher than normal implied rates – in very short-term EURUSD FX forwards that mature just past the turn. But that's pretty much it. So, the pendulum is very much still swinging *away* from Eurozone banks boosting their leverage ratio by cutting back on various exposures, leading to excessively low euro rates over the turn. Which begs the question: since the turn is shaping up to be a non-event, are we not moving to a world where banks are trying to window-dress their liquidity instead? The short answer is no, at least not on a Euro Area-wide level. However, I will be looking at the member state level data and other data for signs that, in the margins, we see real demand for liquidity over the turn for window-dressing purposes. So, window-dressing liquidity – either regulatory or simply balances with the Eurosystem – instead of window-dressing the leverage ratio.
- **The table on the next page shows the overview of factors that influence the turn to various extents.** As mentioned before, the turn is measured by the premium in the Dutch T-bill over the constant maturity ESTR swap with the same maturity date. Since the table has increased in both columns and rows, I need a full page. Apologies for that:

Money Market Update

	2025/2026	2024/2025	2023/2024	2022/2023	2021/2022	2020/2021	2019/2020	2018/2019	2017/2018
Banking system liquidity									
Excess liquidity (EUR billion; adjusted for tiering)*	2,585	3,082	3,634	4,500	3,467	2,440	1,155	1,876	1,841
Excess liquidity (net of tiering) to total assets, quarter-end value*	6.0%	7.5%	8.9%	10.9%	8.6%	7.0%	2.9%	5.7%	5.7%
GSIB Q4 Liquidity Coverage Ratio**	140.6	141.3	150.0	145.9	152.0	160.8	132.1	136.7	134.4
All wholesale deposits to total assets, Q4 average*	11.5%	11.7%	11.7%	11.9%	12.1%	11.7%	10.8%	10.8%	10.5%
MRO/LTRO borrowing over the turn (EUR billion)		8.1	5.7	---	---	---	5.4	---	---
Banking system leverage									
Leverage ratio Q4, all ECB supervised banks		5.48	5.37	5.14	5.20	5.27	5.54	5.34	5.45
Leverage ratio Q1, all ECB supervised banks	5.40	5.28	5.08	4.88	5.07	5.01	5.21	5.19	5.06
GSIB Q4 leverage ratio		4.36	4.37	4.43	4.54	4.53	4.73	4.58	4.63
GSIB Q3 leverage ratio***	4.45	4.29	4.40	4.27	4.40	4.32	4.30	4.28	4.49
Money market									
Median Q4 Stoxx deferred repo to ECB deposit rate spread****	0	-1	-4.7	-13	-4.8	-1.0	1.9	-1.3	-2.0
Median Q4 6-Month Bubill yield to ECB deposit rate spread****	-2.83	-0.495	-17.3	-53.6	-16.9	-22.4	-12.6	-29.5	-36.3
GC Repo - ECB depo spread in bps, final trading day of the year		-37	-35	-110	-151	-23	3	-4	-34
Highest BPS premium on Janaury DTC*****	12	37	42	107	76	63	49	62	115
EURUSD 3-month basis, Q4 low*****	-5.25	-9	-33	-35	-42	-34	-18	-50	-101
Collateral and Treasury bills									
Bank reserves to collateral ratio, Q4*	0.39	0.49	0.63	0.77	0.73	0.63	0.27	0.56	0.59
Germany public debt to GDP excluding ECB/Eurosystem holdings**		47.1%	45.0%	44.7%	47.3%	49.5%	43.8%	45.7%	50.2%
Share of German Federal securities held by the ECB/Eurosystem**	20.9%	23.2%	27.0%	30.9%	31.8%	28.2%	27.7%	27.0%	23.4%
T-bills issued by Germany, France, Netherlands, Austria, Finland, Belgium, EU to Euro Area GDP**	2.67%	2.91%	3.01%	2.89%	3.05%	3.22%	1.45%	1.55%	1.61%
ECB securities lending window: YTD highest daily balance (EUR billion)	90.0	99.9	127.5	157.1	167.4	94.5	54.7	78.2	87
ECB securities lending window: highest daily balance: date	03-01-2025	05-01-2024	30-06-2023	31-12-2022	31-12-2021	31-12-2020	08-03-2019	29-03-2018	29-12-2017
Other									
Global policy uncertainty index, Q4 median (long term average = 186)****	291	212	222	255	209	203	358	232	176
YTD change US 10 Treasury yield in bps	-43	24	0	261	60	-100	-86	49	-9
Banks Single Resolution Fund funding round	No	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Notes	Substantially lower liquidity levels, but reserve demand remains low	Higher rates, smaller central bank balance sheets, rising government debt	First turn without SRF funding, live ECB rate cut pricing, ECB QT	First year turn in rising rate environment	Liquidity levels at highest ever recorded and rising further	First annual turn since Covid shock	Tiering introduced, effective excess liquidity down 40% to EUR1 trillion.	For the first time since 2014, barely any growth in ECB monetary policy assets.	Basel III fully loaded leverage ratio became active by January 2018

*for 2025/2026 Q3 2025 data

**for 2025/2026 2025 Q2 data

***for 2025/2026 Q3 estimated based on quarterly earnings

****For 2025/2026 Q4 data through latest datapoint

***** data October 1 to mid-December to exclude extreme outliers; from 2022/2023 spread with ESTR OIS; 2024/2025 is Q4 data through latest available data point

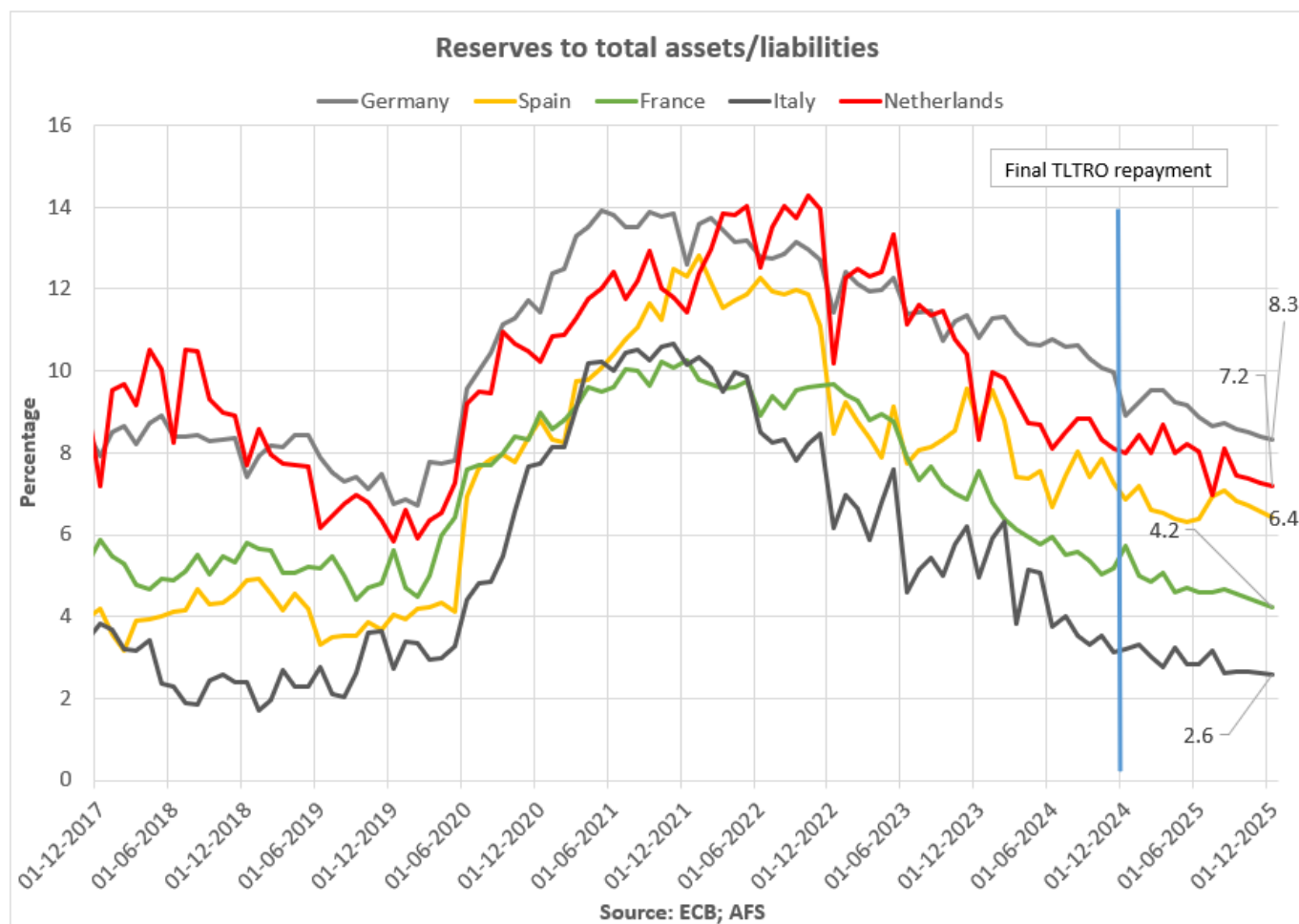
***** from 2022/2023 SOFR/ESTR Basis. For 2025/2026 up to latest available data point

Source: ECB SDW; SSM; Federal Reserve; Bloomberg; Eurostat

- **Factors with meaningful correlation coefficients of 0.7 or greater with the turn's severity as measured by the premium on the Dutch T-bill are:** the 6-month constant maturity Bubill – ESTR swap spread; the dollar's premium in the basis; and the leverage ratio of all ECB-supervised banks in the first quarter.
- **If you study the data in the table in detail, you will notice that the more liquid and the more leveraged the banking system is, the more depressed euro rates will be over the turn (denoted with red cells).** Furthermore, when collateral is scarce, as measured by pricey Bubills or a high share of Eurosystem ownership of German sovereign debt, this depresses interest rates over the turn. The dollar commanding a stiff premium in the basis also does the same thing.

- **In the past, banks had to contribute to the so-called Single Resolution Fund, or SRF, which is responsible for financing failing banks.** Because the fund has reached its target size relative to bank deposits, banks no longer contribute to the fund, and thus no longer need to massage their deposit base lower to get their contribution down.
- **When we look at the Q4 leverage ratios through time, we see that ratios are back to their pre-pandemic norm.** Meaning less of an incentive for banks to cut back on exposures ahead of the reporting date. Notice that too-big-to-fail GSIBs² have lower ratios for obvious reasons – because they simply can get away with it.
- **For reasons that still elude me, the Q1 leverage ratio of all ECB-supervised banks correlates strongly with the severity of the year turn.** Perhaps Q1 gives a better snapshot of the banking system real leverage ratio since it is not affected by year-turn window-dressing (only quarter-end window dressing I'm afraid).
- **The thing that excites me the most in the table, is MRO/LTRO borrowing over the turn.** Yes, borrowing levels are low and will likely remain so for a while. I have been very disappointed by uptake this year – there has been no growth. Still, I think we will see a bit more borrowing this year. After all, it's a cheap and easy way for banks to boost their (regulatory) liquidity by simply pledging lower quality collateral.
- **I am particularly interested in borrowing behavior of French and Italian banks, who have the lowest liquidity levels of the banking system in the five biggest member states.** If my forecast turns out to be right, by year-end the reserve to total assets/liabilities ratio for French will be barely above four percent, the lowest level since the ECB embarked on QE more than a decade ago:

² GSIBs are defined as Eurozone banks that are on the FSB list of globally systemic banks.



- **If you look really closely, you may have noticed that French banks' reserve ratio rises over the turn before falling in January (which I did not take into account in the forecast).** Now, French bankers told me that this increase in liquidity levels over the turn is because of cash from money market funds returning home briefly for whatever reason. Most of these funds are in Luxembourg. So, if there's an exodus of wholesale cash and corresponding bank reserves to France from Luxembourg, that would show up in the ECB's monthly bank balance sheet data (MFI data for the incrowd). Alas, this is not the case. The pattern in bank reserves is that French banks indeed do 'borrow' substantial amounts over the turn, with the reserves coming from Germany and the Netherlands mainly. Notice I write 'borrowing' because I do not know the motivation for the trade. Since it's a recurring seasonal phenomenon even during peak-pandemic liquidity, it might very well have nothing to do with borrowing intended to polish liquidity ratios.
- **And speaking of liquidity, I mentioned before that MRO recourse over the turn is the thing that I will be watching the most.** The most interesting titbit will be uptake per member state. Early February, when the ECB publishes the balance sheet breakdown of the Eurosystem on January 2, we will know where turn-driven liquidity demand over the turn comes from. Stay tuned, though I hope to publish another money market update on some other topic before February (fingers crossed).

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