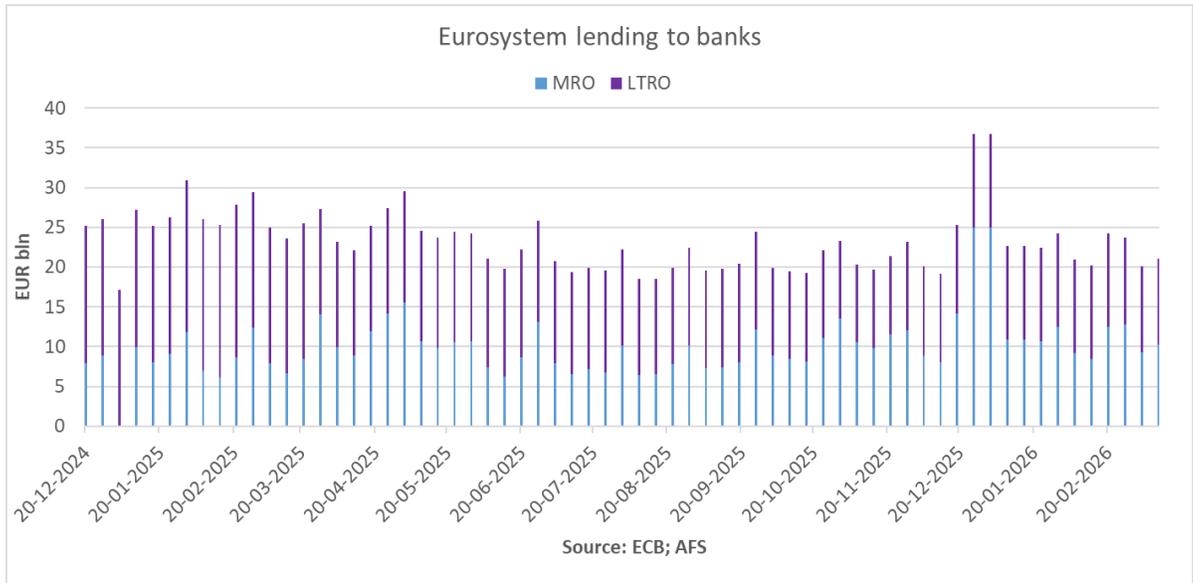


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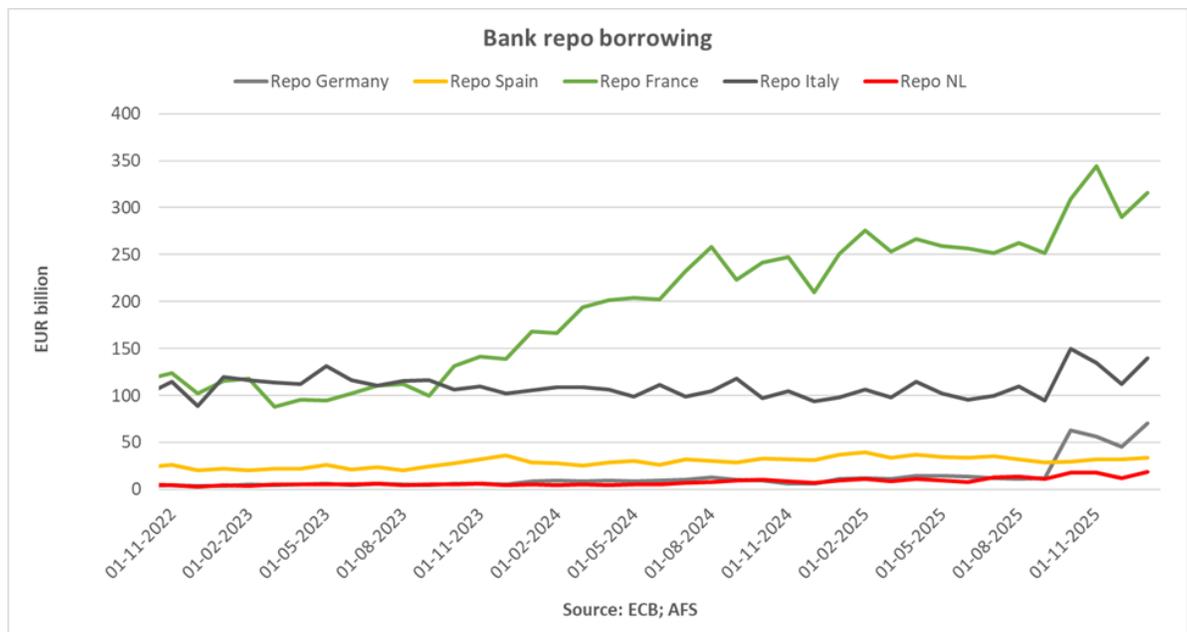
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Change is coming... in 2027

- **Everybody talks book.** Even analysts at money brokers. Take my money market forecasts. For this year, I have forecasted money market spreads that are generally stable in the sense that spread tightening is gradual and linear and proportional to the decrease in excess bank reserves stemming from ECB QT. From a business perspective (our money brokerage business), that's not great. I can't deny that our business would do better if Eurozone money markets were a bit more volatile and exciting. Fortunately, I think the money market will change... next year. Perhaps – dare I say – drastically so. I think spread tightening will accelerate. In the case of the secured market, we might reach the steeper part of the demand curve for reserves. About the unsecured market I am less sure – my ESTR-DFR spread model points to spread tightening proportional to ECB QT as far as the eye can see (through December 2027). However, my new model for regulatory, LCR-driven demand for reserves points to exactly that: a notable increase in demand for reserves to meet internal regulatory liquidity targets over the course of 2027. I think that increased regulatory demand for reserves will tighten the ESTR-DFR spread faster than my ESTR-DFR spread model envisages. I know that higher regulatory demand for reserves pushing up ESTR appears to make no sense as overnight borrowing is relatively unattractive from a regulatory point of view. But please be patient and bear with me.
- **Before delving into the new model, I want to give a brief overview of the latest money market (spread) developments.** To show where we are coming from – the current easy money market conditions (relatively speaking of course).
- **Starting with uptake at the Eurosystem's regular MRO/LTRO operations.** Uptake has stayed dismally low in the twenty to twenty-five billion euros range:



- Remember that even the ECB has become impatient with banks not showing up at the MRO/LTRO window.** Last December, Lagarde & Co sent out a press release begging the banks to try the facilities every now and then. You see, even our central bank overlords talk book. They make a 15bps profit on lending to banks. The Eurosystem has racked up tens of billions of euros in losses on its bond holdings. Every small profit is a godsend.
- Elsewhere, nothing is going on with my latest obsession, French banks.** According to monthly balance sheet data (MFI series), there was a cyclical increase in French banks' repo borrowing in January following the usual seasonal window-dressing dip in December. But, as the chart below shows, the increase in secured borrowing by French banks is in line with German and Italian banks' repo borrowing increase that month.



- Furthermore, with France's budget 'solved' (for a while at least), the Bund-OAT spread has compressed strongly – until the war with Iran turned it**

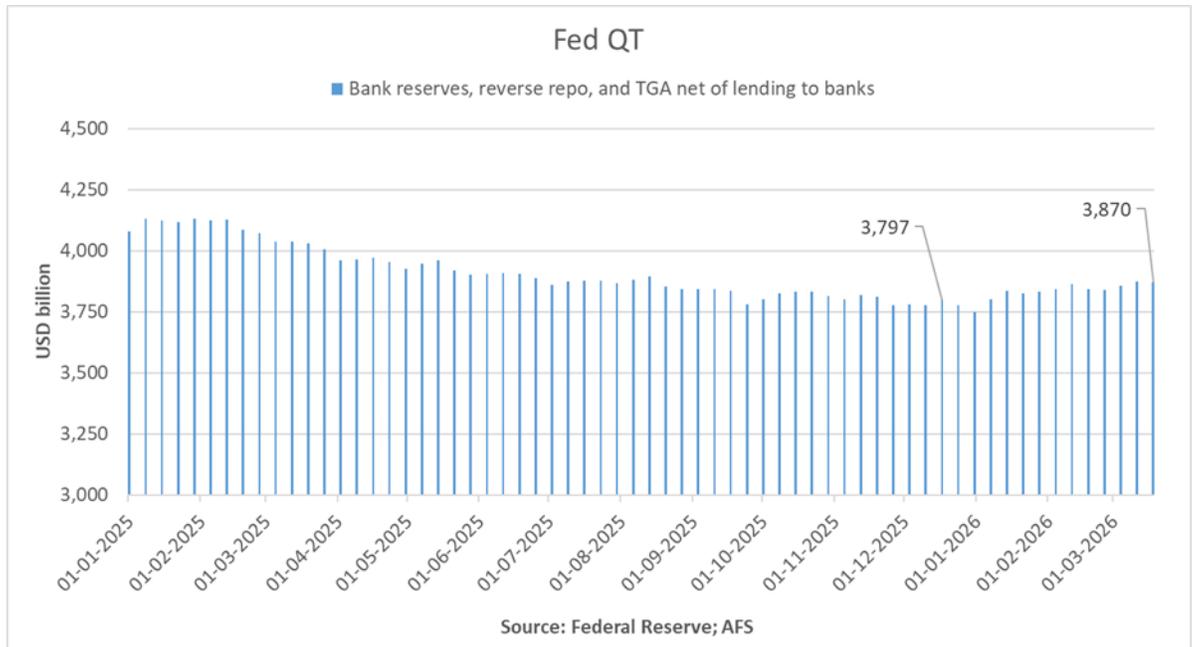
around. In 2024 and intermittently in 2025, Bund-OAT spread widening was associated with an increase in French Target2 liabilities, and thus French banks losing reserves to banks in the rest of the Eurozone. That's no longer happening. In fact, I wouldn't be surprised if French banks will claw back reserves from other parts of our wonderful currency union.

- **Another trend worth discussing is the basis.** These days, the euro trades at a premium in the basis:

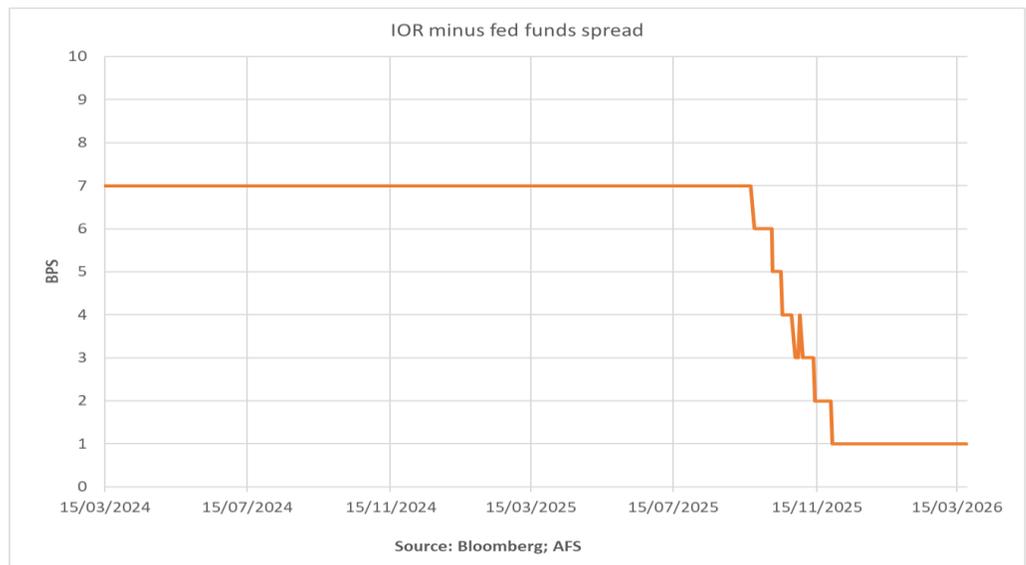


... though the premium has evaporated since the outbreak of the war in Iran.

- **Interestingly, covered interest parity doesn't apply either in FX swaps.** Banks that can borrow USD on the cheap onshore (around fed funds) and are able to swap to euros, can then place the euros at the Eurosystem for a tidy riskless profit of about 10bps currently.
- **The dollar's vanishing premium in the basis reflects the diverging paths of the Eurosystem balance sheet on the one hand, and the Federal Reserve balance sheet on the other hand.** The former is shrinking while the latter has started to grow again.
- **The Fed resumed asset buying in mid-December last year.** Purchases are intended to increase the overall level of reserves to an ample level. It is my understanding that ample is defined as the level at which recourse to the standing repo facility is low as possible: basically zero. The experience with last year's mini repo market crunch has taught me that the Fed is uncomfortable with backstopping the secured money market by doling out large amounts of bank reserves with its standing repo facility.
- **Since mid-December, the Fed's Treasury bill holdings have increased by USD170 billion.** That may sound like a lot, but purchase amounts have actually been tame. Liquidity conditions, defined as the sum of bank reserves net of lending via the discount window/repo facility; the Treasury's account at the Fed; the reverse repo balance at the Fed, have increased modestly. By as little as USD70 billion:

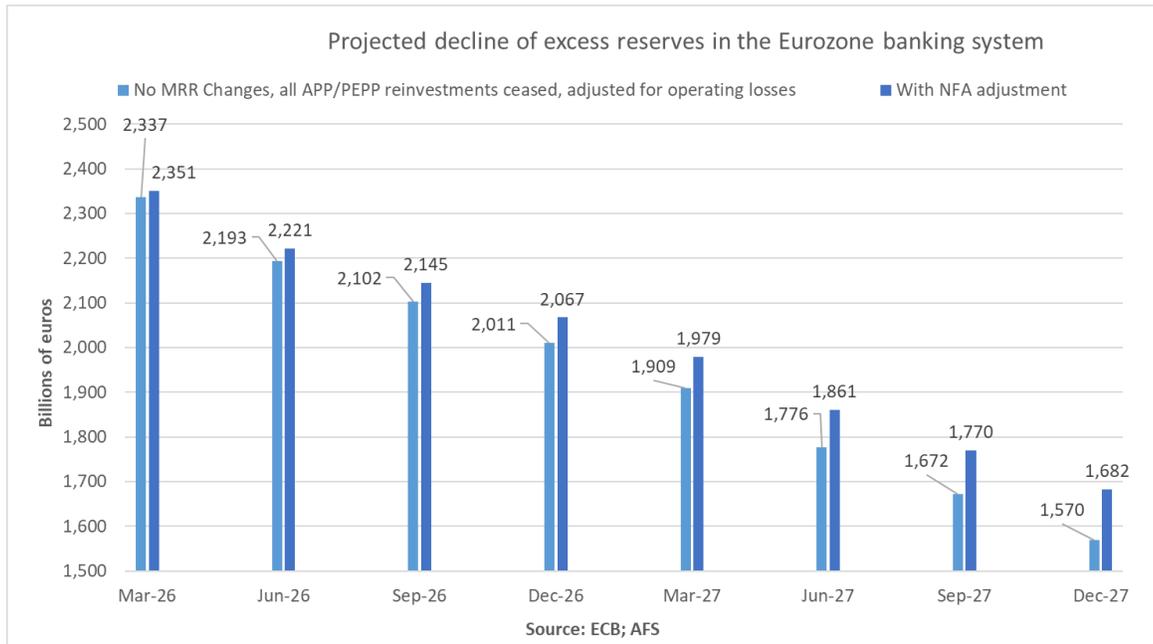


- **Other factors on the Fed balance sheet have sterilized much of the reserve management purchases.** Principally the continued roll-off of Mortgage-Backed Securities, but also some miscellaneous items. The result is that while reserves are higher than they were in mid-December, we're still a bit below the summer of 2025 levels, when US money market spreads hadn't yet tightened much.
- **With only a relatively small easing of US onshore liquidity conditions, money market spreads have remained tight:**



- **Still, the Fed has prevented blowouts in SOFR, GC repo, and tri-party GC repo.** Furthermore, as mentioned before, recourse to the standing repo facility has been reduced to minimal amounts.
- **In stark contrast with the Fed stands the ECB's balance sheet policy.** The ECB has published the Quantitative Tightening (QT) redemption schedule through December 2027. With some understanding of autonomous factors on the

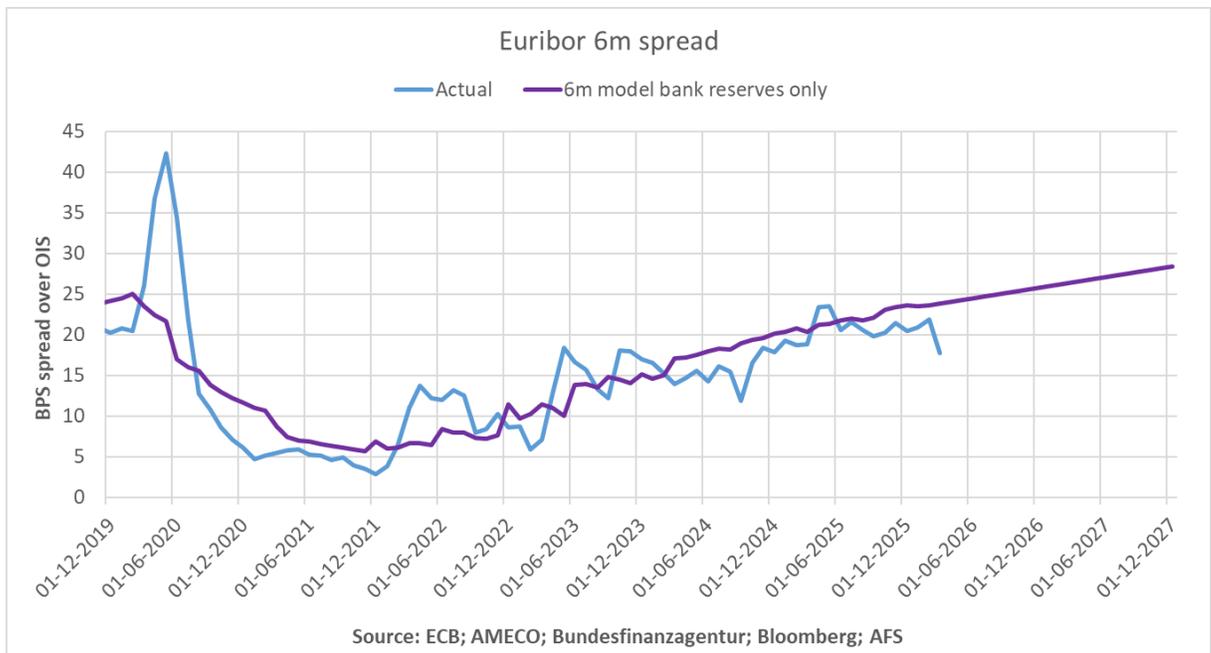
Eurosystem's balance sheet, future liquidity conditions can be predicted with high precision.



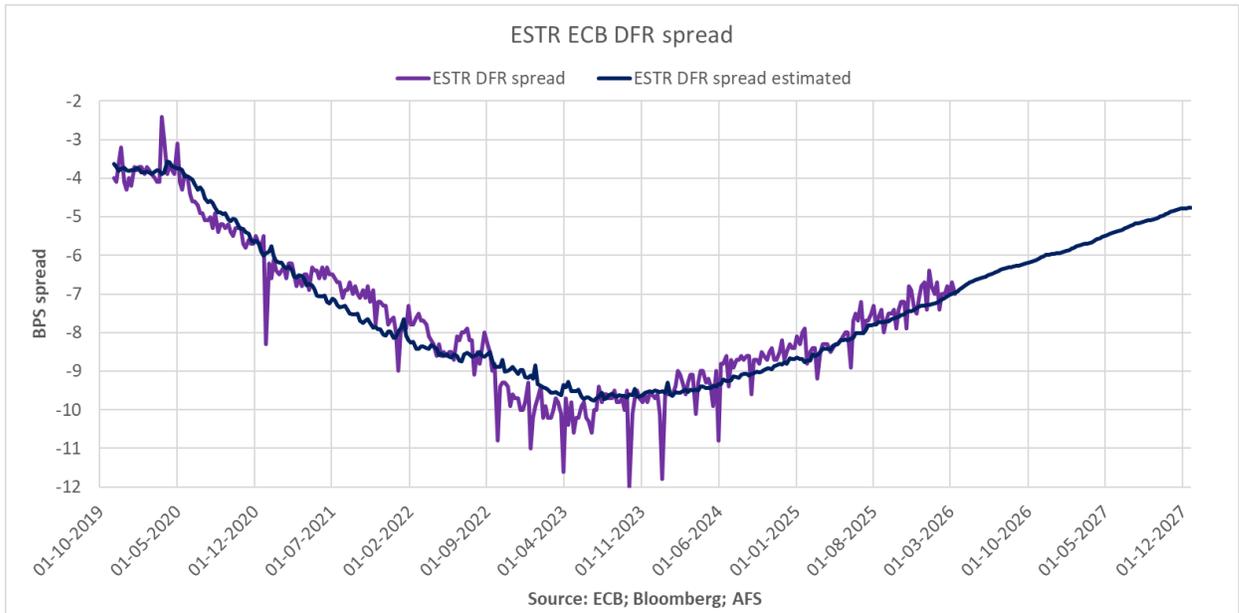
- **NFA stands for Net Financial Assets, which by and large involve securities buying for non-monetary policy purposes.** Which the ECB does in small but still meaningful amounts. Be aware that I make assumptions about the Eurosystem's operating losses. These losses add reserves, though absolutely not in a game-changing way.
- **The ECB has made it perfectly clear that it wants banks to turn to the MRO and LTRO to satisfy (regulatory) demand for reserves.** The contrast with the Fed could not be starker. The ECB wants to push reserves to such low levels that banks will be forced to show up at the MRO/LTRO window. The Fed, on the other hand, prefers as little borrowing by banks as possible. Unless Fed Chairman nominee Warsh wants to try to go back to a leaner (not lean!) balance sheet, the Fed will purchase securities in such amounts that recourse to the repo facility remains low and as close to zero as often as possible.
- **Banks got the message that MROs and LTROs are there for them to be tapped when necessary.** But according to my inquiries with a highly sophisticated and representative panel of Eurozone bank IR departments show that many bankers aren't thinking about a world where MROs/LTROs are a necessity, not convenience.
- **Specifically, I asked six big Eurozone banks (ING, Deutsche Bank, BBVA, Credit Agricole, BNP Paribas, and Intesa Sanpaolo) about their views on MRO/LTROs: stigma or no stigma, part of their funding plans, and related sundry questions.** The answers can be summarized as follows. Where the ECB has succeeded, is removing most of the stigma associated with Eurosystem borrowing. No bank complained about running the risk of being stigmatized when borrowing from the Eurosystem. Only Credit Agricole's IR department matter-of-factly said some banks (not Credit Agricole itself of course!) may still run into problems with their regulators when borrowing from the Eurosystem.
- **Every bank has a stock of credit claims ready to be pledged as collateral for Eurosystem borrowing.** Makes a lot of sense. Intesa and BBVA show the least

willingness to borrow from the Eurosystem, saying that they are aptly funded for as far as the eye can see. Perhaps surprisingly, ING and Deutsche Bank are the most receptive to Eurosystem borrowing, saying that they could use the facilities opportunistically. No bank has incorporated Eurosystem borrowing as a structural part of its funding plan. Deutsche Bank said that the MRO/LTRO are only part of the funding puzzle (read: good for LCR, useless/less useful for NSFR). Only BNP Paribas – the smart lot – is willing to envisage a world where MRO/LTROs are a necessity and considers structural recourse.

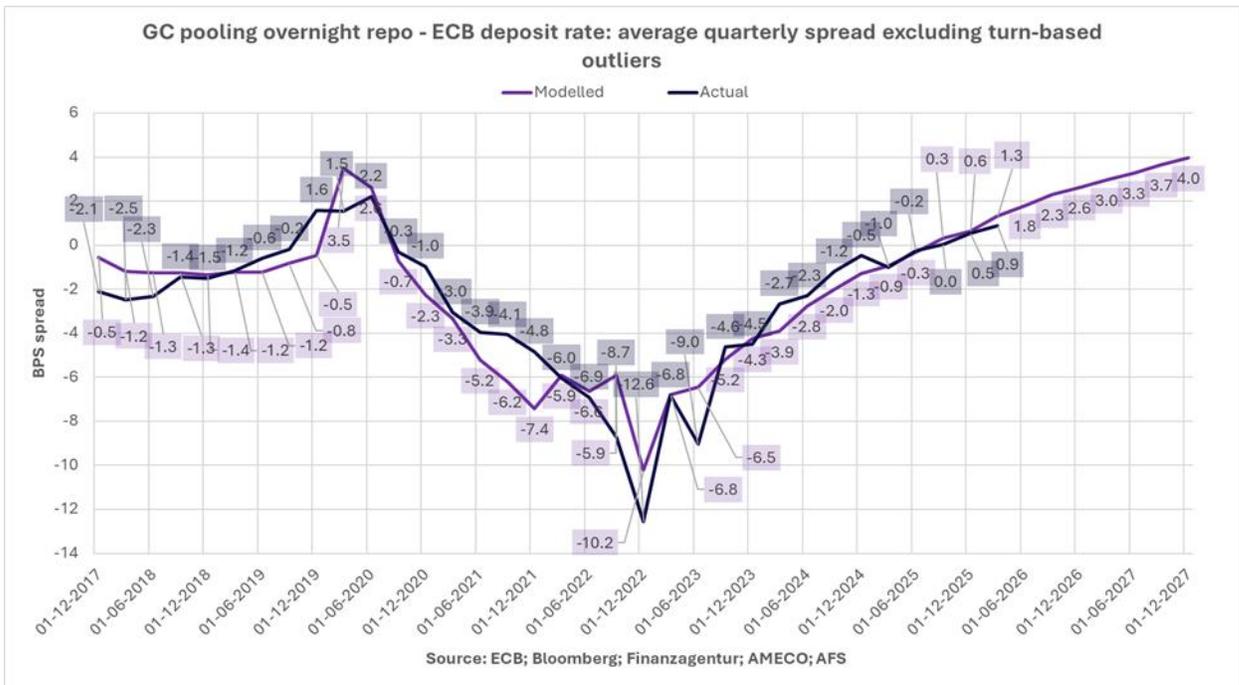
- **When looking at money market spread developments, it's understandable that banks' funding departments aren't thinking much of a tight money market or reserves being scarce.** Euribor-OIS spreads aren't exactly screaming tight market. On the contrary: spreads with ESTR OIS have collapsed because of the war. Regardless, even before the war messed things up, the 6-month Euribor-ESTR spread lagged my model. Before the outbreak of the war we had returned to pre-pandemic levels, which isn't exactly tight.



... which can't be said about the **ESTR-DFR spread**. The ESTR-DFR spread continues to tighten at a leisurely pace and fully consistent with my model based on unborrowed bank reserves (government bond holdings net of autonomous factors):



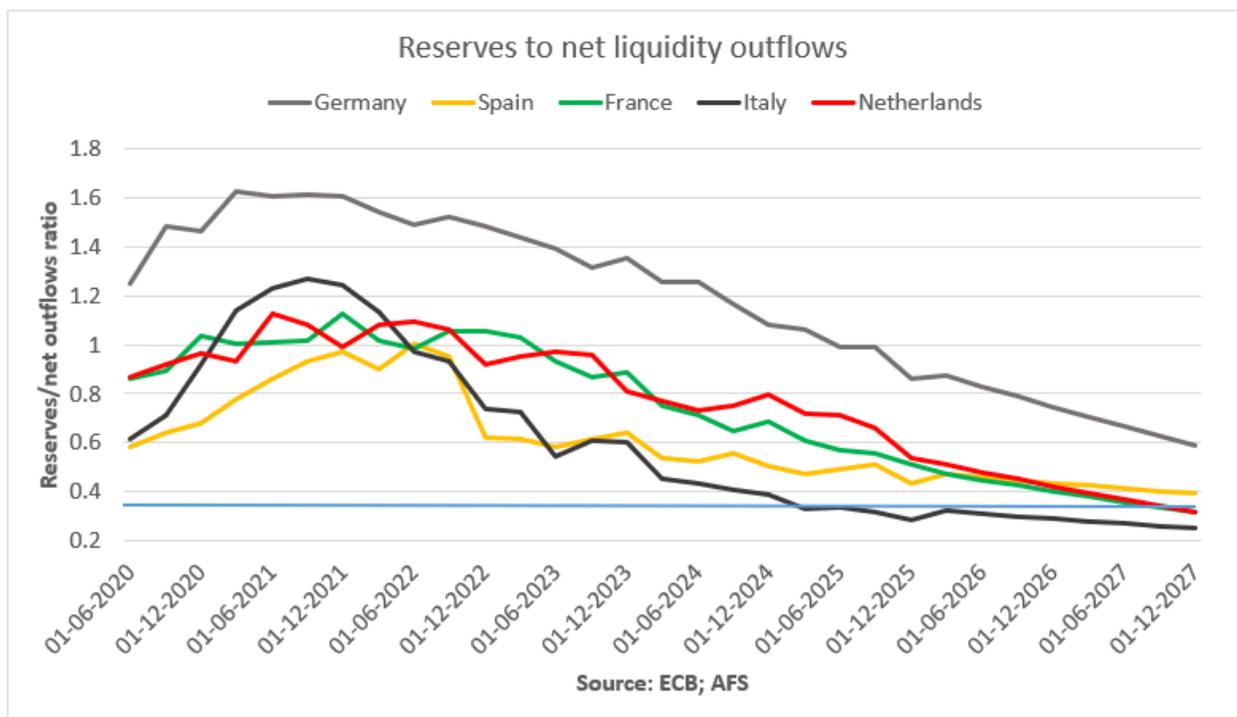
- **For meaningful tightening one must turn to the secured market.** My two-year old model still perfectly captures the spread tightening of the Eurex GC pooling rate (I am still waiting for an invitation from Eurex to present my model):



- **For the record: the model's independent variables are bank reserves relative to collateral originating from the core Eurozone member states plus supra debt.** Collateral is defined as Dutch, French, and German government debt, debt from agencies headquartered in these countries, supranational issuers (EIB, EU), and extreme high-quality covered bonds. In any case, were it not for repo dropping below DFR during the period of secured market looseness late January, the average spread for the first quarter would be 1.4bps, not one bp.
- **Notice how the repo-DFR spread will return to its pre-pandemic level around the summer.** It's anyone's guess if and when spread increases will accelerate

and will be disproportionate to the decrease in bank reserves and the increase in collateral. If I had to guess, I think spread tightening will accelerate over the course of 2027, and that will also tighten ESTR-DFR.

- I think the dichotomy between relatively wide unsecured spreads and tight secured spreads can be explained by how ECB QT is ‘absorbed’.** Since the summer of 2022 peak in Eurosystem bond holdings, holdings have declined by 1.262 billion euros. At the same time, the money supply M3 increased by 1.414 billion euros while bank lending grew by 958 billion euros. Put differently, the money supply is still up even when we deduct money creation stemming from bank lending. Of course, other factors have contributed to the M3 increase – I don’t want to go into detail here. The key takeaway is that QT probably isn’t doing much in the way of money destruction. Foreign and leveraged buyers are likely in large part responsible for mopping up the bonds that roll off from the ECB balance sheet. If leveraged buying is responsible for much of the QT absorption, of course the secured market (where the trades are financed) will tighten faster than the unsecured market.
- I want to conclude with my LCR-model.** Better said: net outflow model, which I use to gauge purely regulatory demand for reserves – not just an abstract reserve to total assets/liabilities ratio. The key assumption is that banks want to hold 25 percent to 30 percent of their High-Quality Liquid Assets (HQLA) in reserves. Assuming banks target an LCR of about 140 percent, that equals 39 percent of net liquidity net outflows. Net outflows? I use net outflows because it’s very easy to forecast with simple linear extrapolation. And since the future level of bank reserves can be estimated with good precision, forecasting future regulatory demand for reserves is straightforward.
- In the chart below are reserves (taken from the MFI data series) to net liquidity outflows according to the supervisory SSM data.**



- **The ratio for Italian banks fell below the 39 percent threshold at the 2024/2025 year turn, when banks had just repaid the final TLTRO tranche.** Ever since, LTRO/MRO demand has fluctuated around 20 billion euros, with the bulk of the lending done by the Bank of Italy. Since the year turn, reserves to net outflows of Italian bank has hovered around 30 percent. Which is substantially lower than the estimated minimum. So, estimated minimum of 39 percent could be off. That, or Italian banks are comfortable with meeting net outflows with a lower level of reserves. In any case, I need not to remind you that the MRO and LTRO are very LCR-friendly: borrowing from the Eurosystem carries a factor of zero for outflows while it boosts HQLA one-on-one.
- **Notice that on a consolidated level Dutch and French banks will fall below the 39 percent threshold a year from now, while Spanish banks German banks will remain more liquid.** Given that French banks have relatively low reserves to total assets/liabilities, I expect to see French banks start tapping the ECB facilities more and in significant amounts over the course of 2027, followed by Dutch banks. Of course, with these forecasts I make assumptions about changes in Target2 balances and the redistribution of bank reserves. To be more precise, in the chart above I assume that: Dutch and German Target2 claims fall gradually; while Spanish and Italian liabilities continue to fall; and French liabilities are stable. Of course, Target2 balances change primarily because of hot money flows, a variable that is simply impossible to forecast.
- **I want to emphasize that the only way for banks to increase their stock of reserves relative to net outflows it to borrow from the Eurosystem or from other depositors at the Eurosystem: member state treasuries and supras.** The latter is limited in nature, while the former is limited only by the collateral that banks can pledge. Of course, banks will still try to 'steal' reserves from other banks by paying better. Hence my call that ESTR-DFR spread increases will likely accelerate (later) next year. In any case banks that lose reserves must tap the ECB.
- **So, to conclude, I expect a different money market in 2027.** There will be a notable pickup in demand for reserves, with faster tightening of money market spreads. Banks in France and the Netherlands will start to turn to the Eurosystem for the LTROs/MROs as to polish their regulatory liquidity. Opportunistically at first, but structurally as time goes by.

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