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Money Market Update:

Higher reserve requirements will squeeze Italian banks

Miracles don’t last

September 23, 2026

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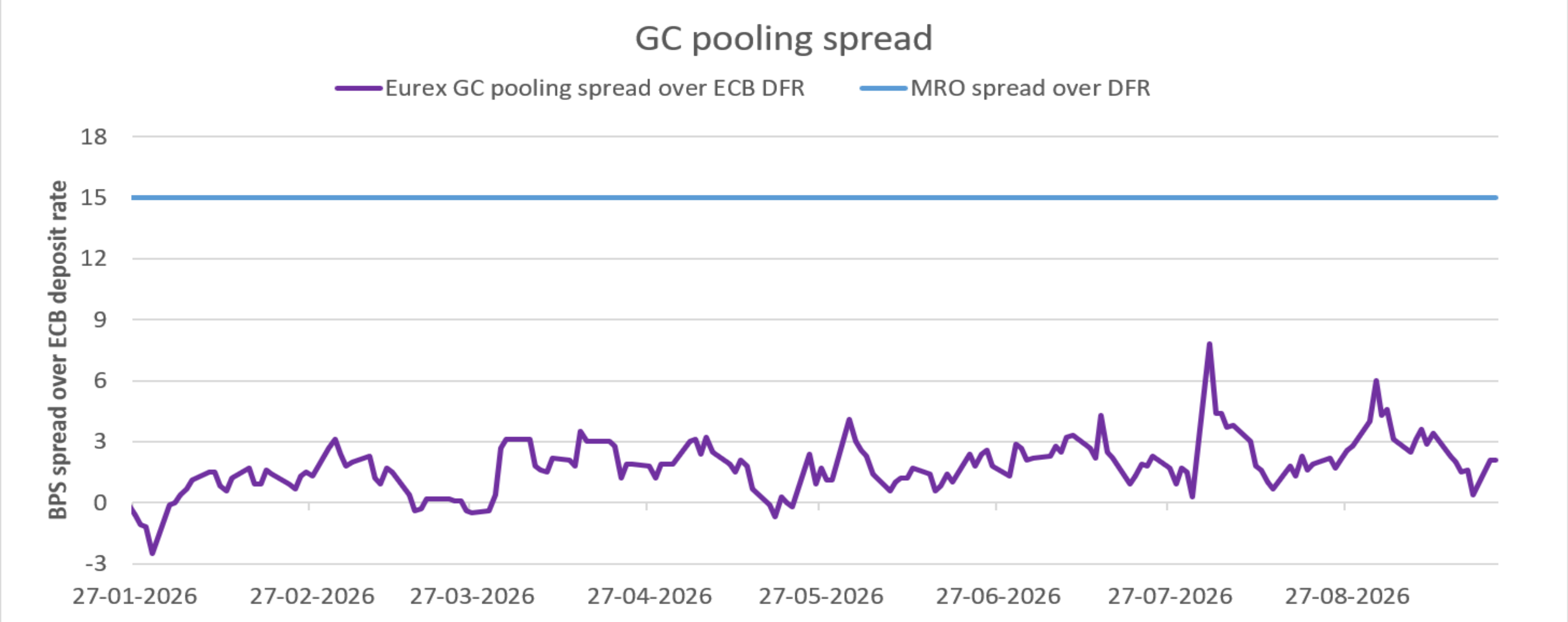
My own private repo market crash

- **GC repo versus ECB DFR spread tightened strongly later in the summer**, though it fell well short of the MRO cap (banks can always pledge the collateral for refinancing at the Eurosystem instead);
- **According to our market intelligence**, DMOs and related entities – the traditional lenders of cash in the secured market – were substantially less active in the market around late July/early August;
- **Nominally, the MRO rate should function as a non-leaky ceiling for repo.** However, our banker contacts tell us that the ceiling will likely prove to be a bit leaky. The true ceiling could be several bps higher, reflecting inertia of switching funding sources (from market to Eurosystem).



Source: Bloomberg; AFS

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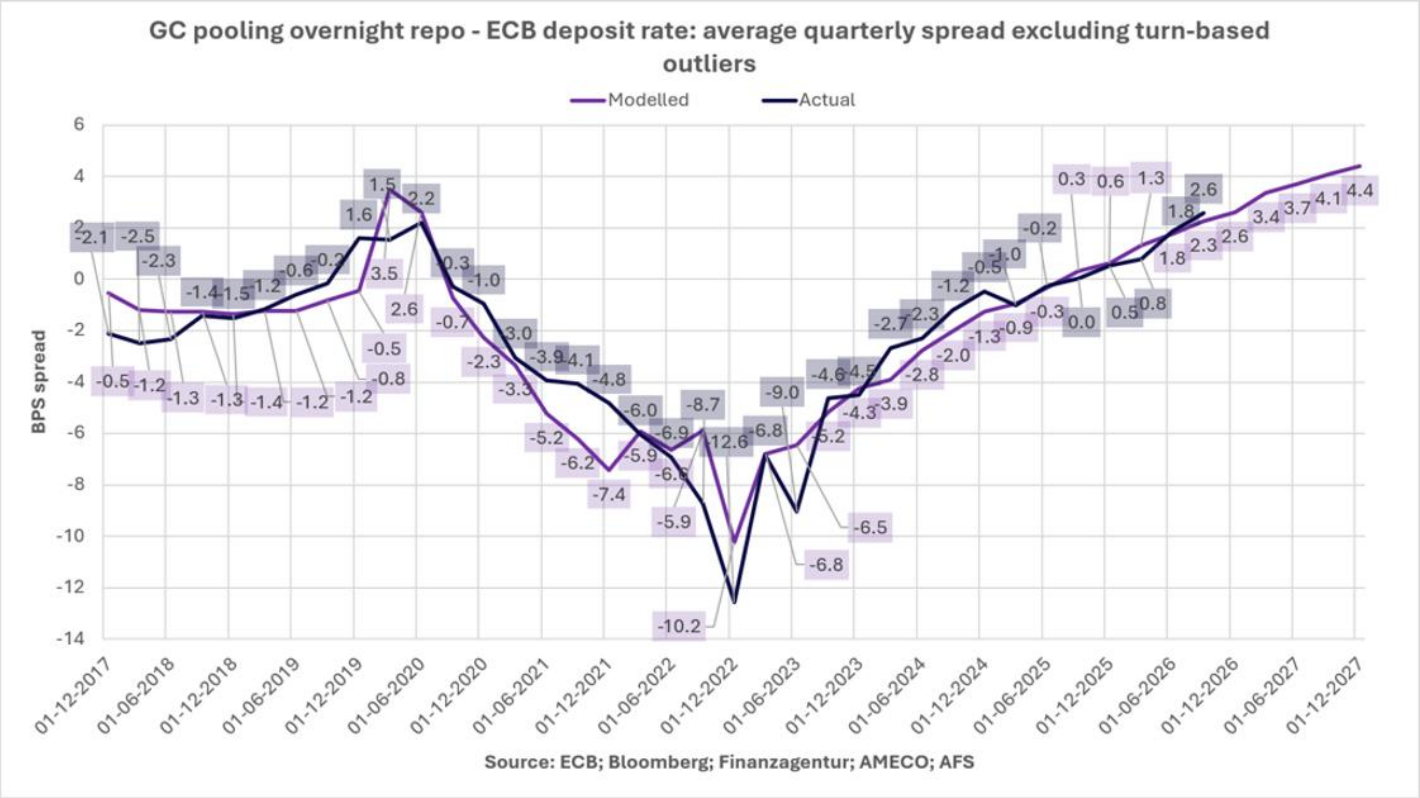
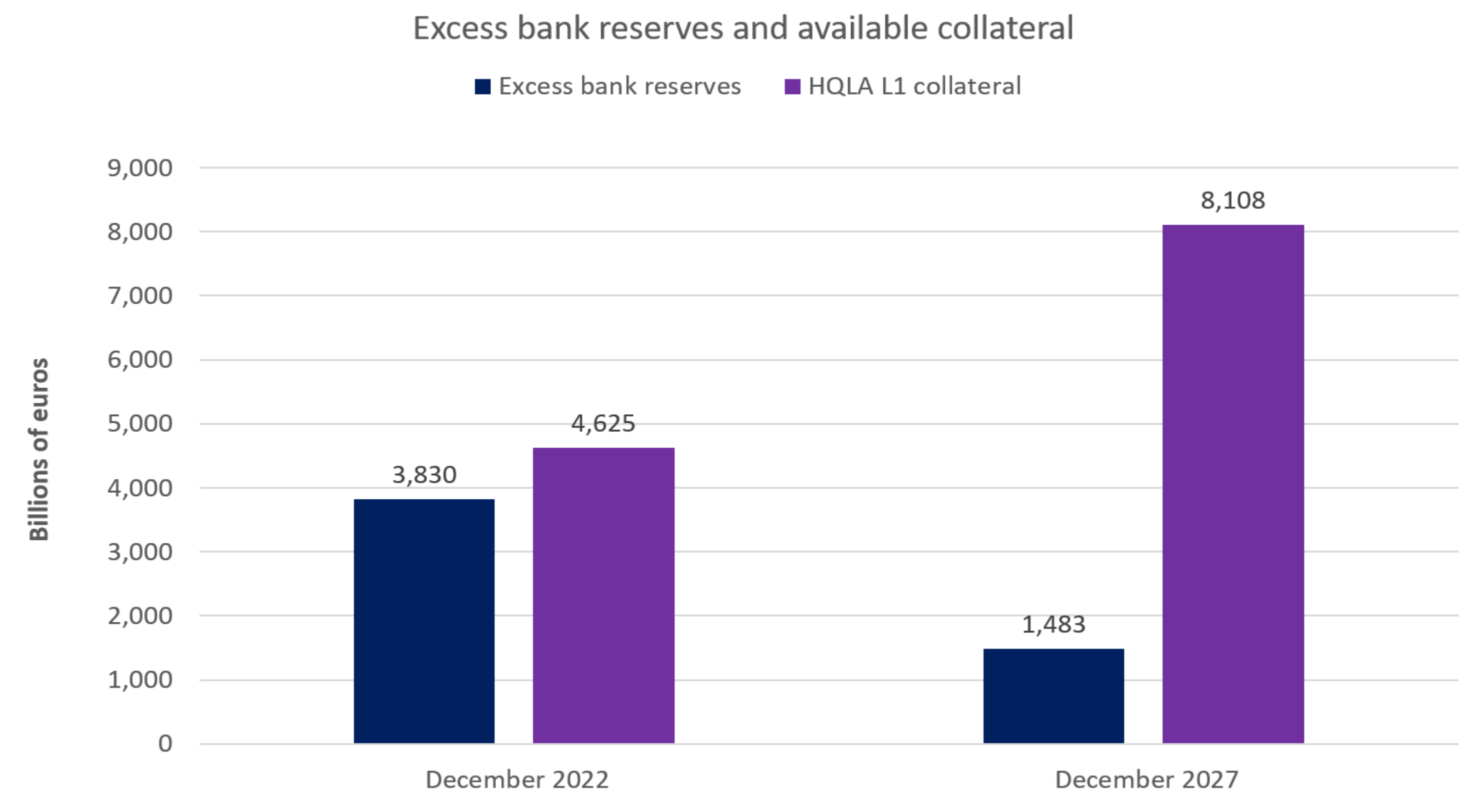
Repo is king

- **Repo market spread tightening versus ECB DFR strongly exceeds tightening of unsecured spreads versus DFR.** ECB QT destroys reserves and releases collateral to the private sector, thereby accelerating spread tightening versus unsecured. The ratio between excess reserves and bonds held by the private sector determines the GC repo – DFR spread;
- **Except for the aforementioned late summer spike in repo rates,** spread tightening has remained proportional to the decline in banking system excess reserves.



Collateral dwarfs reserves

- **Given fiscal slippage across the Euro Area, I will likely up my forecast for what I dub 'core collateral': Dutch, French, and German sovereign and agency bonds, as well as supranational (read: EU) bonds.** More collateral relative to bank reserves mean faster increases of GC repo over ECB DFR. We aren't yet at the steep part of the demand curve for reserves though. Hence, my estimate for spread increases will be measured in tens of a bp, not bps.



Source: ECB; European Commission; Bundes Finanzagentur; Bloomberg; AFS

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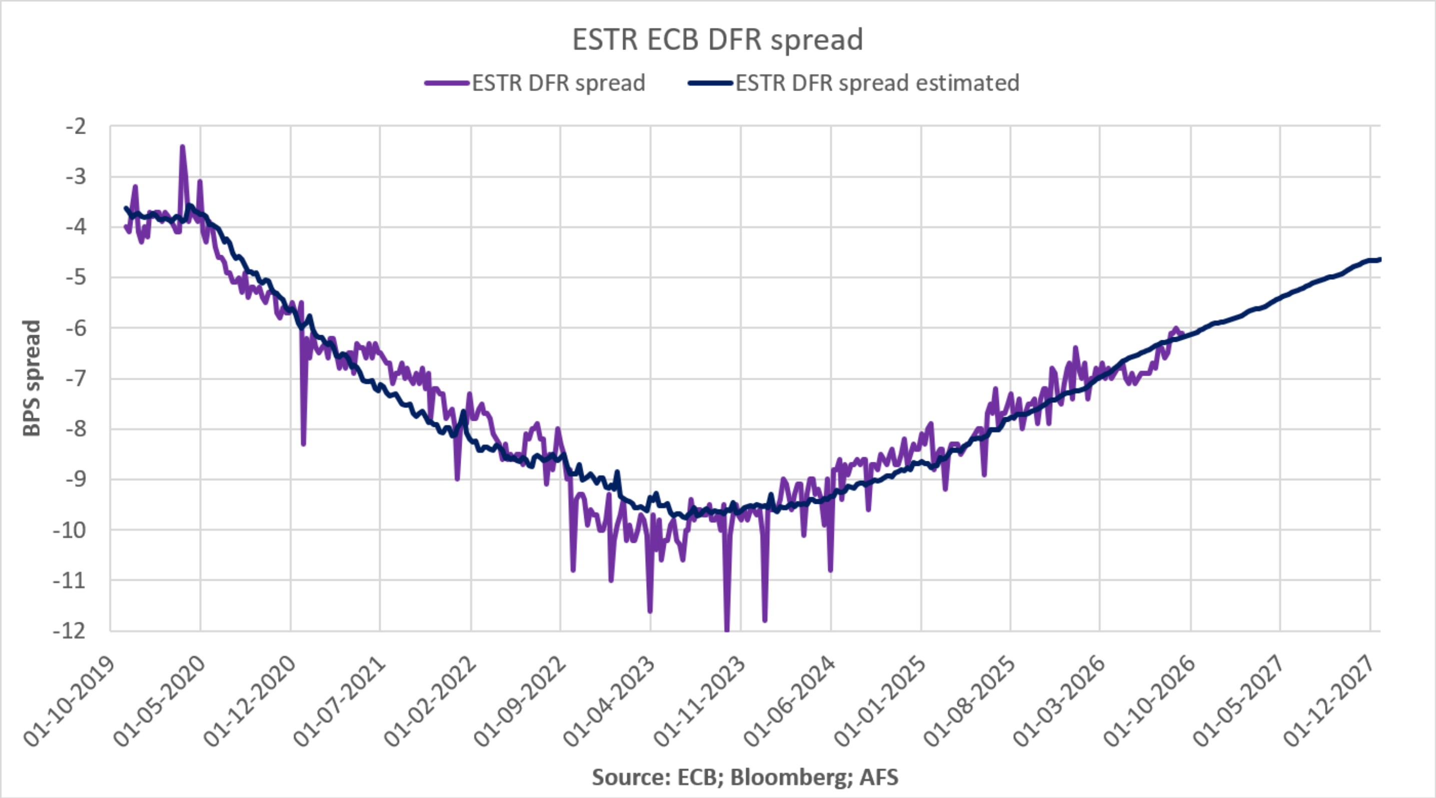
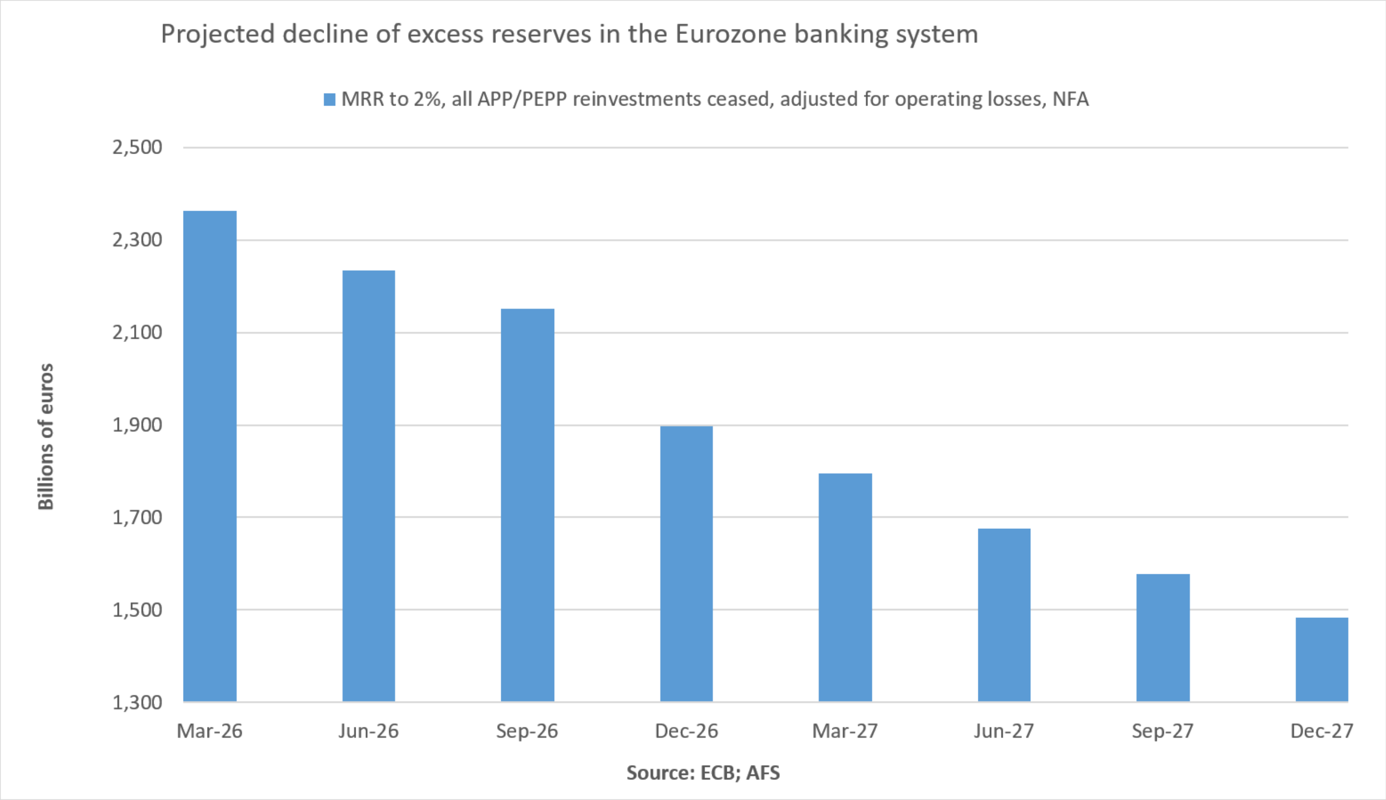
ESTR missed the bus

- **ESTR-DFR spread will not return to pre-pandemic levels before the end of the forecast horizon.** The model below, which has as independent variables unborrowed bank reserves (equal to ECB bond holdings) and autonomous factors on the ECB balance sheet, points to a spread of 4-5bps by year-end 2027;
- **The Minimum Reserve Requirement bump to 2%, which I expect by year-end 2026, will sterilize 170 billion euros in excess reserves.** That should bump the ESTR settlement by a few tenths of a bp, lagging an expected increase of about a bp for GC repo.



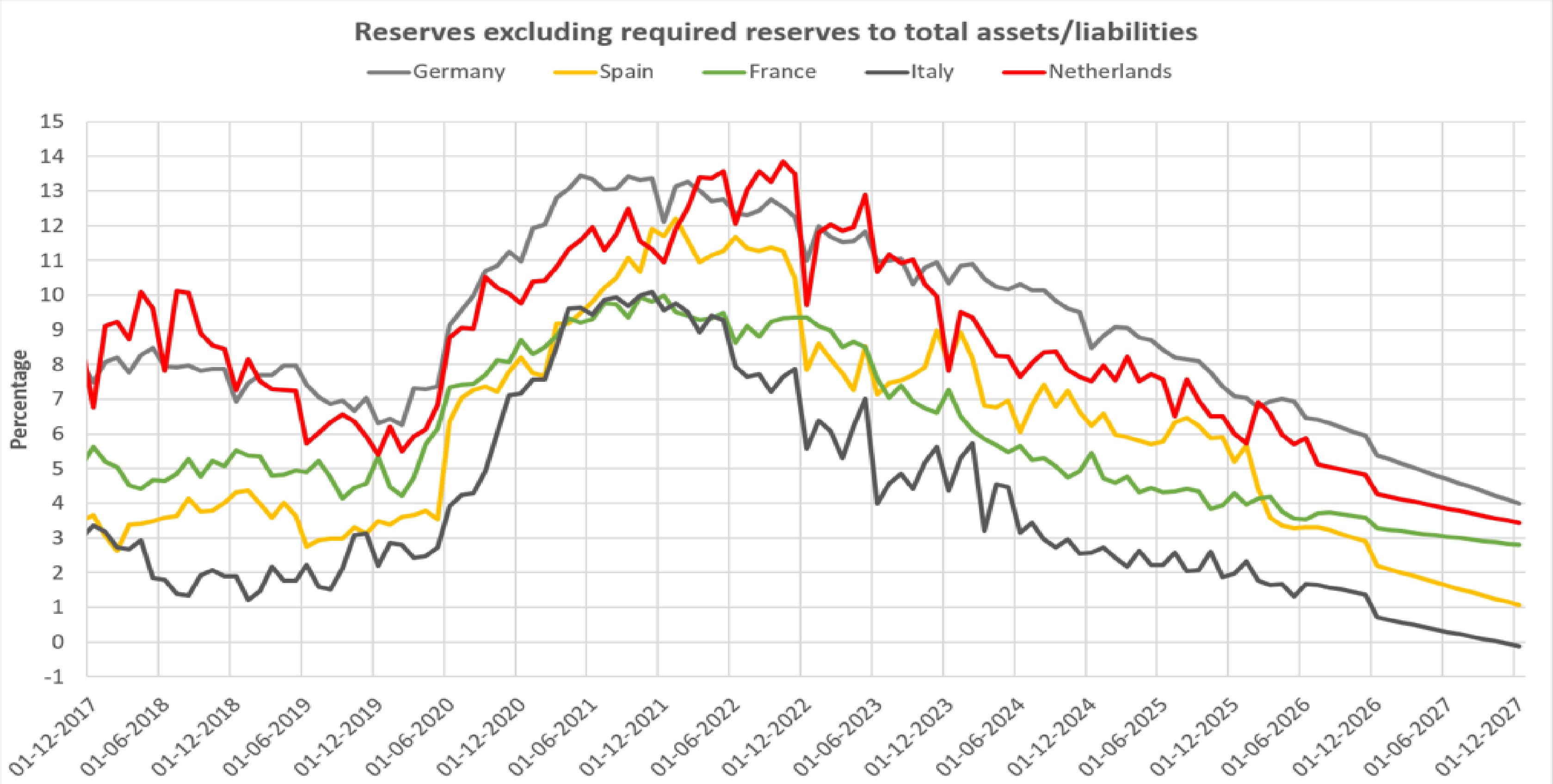
MRR bump to 2%

- **I don't expect the ECB to delay the decision on bumping the MRR to 2% from 1% while maintaining remuneration at zero.** QT destroys about 500 billion euros in bank reserves annually. The lower the level of reserves, the greater the odds that a MRR increase spikes money market rates higher – re the early August spike in GC repo;
- **As a matter of fact, the risks are tilted towards an earlier announcement:** at the October ECB meeting instead of the December meeting baseline.



Italian banks on the receiving end

- **The MRR boost will be most problematic for banks in Italy.** Banks in Italy will see their reserve ratio drop below one percent by year-end if the ECB does boost the MRR to 2%. So, I expect Italian banks uptake of LTROs and MROs to substantially increase. Either in November (if announced at the October ECB) or December (if announced at the December meeting).



Source: ECB; AFS

No more banker freebies

- **Since the ECB is in the business of protecting its own PnL as exemplified by the various remuneration tweaks, the modalities of the LTROs/MROs could be the next victim.** The ECB could end fixed rate/full allotment next year. Or at least make bidding competitive;

- **I don't see why the ECB would grant a new 'structural' LTRO with a tenor of more than three months.** The current LTRO/MRO framework works perfectly well;

- **Supposedly, banks are lobbying the ECB for such a loan that they want to be a Net Stable Funding Ratio booster by design**. I don't see why, but I am happy to be convinced of the merits of a 'structural' LTRO. Regardless, if the ECB introduces a 'structural' LTRO, its spread should be wider than the 15bps over DFR that the LTRO/MRO use. That could suggest a new borrowing rate, which would make ECB monetary policy communication and execution messier;

- **Better to equate the interest rate on a long(er)-term LTRO with the marginal lending facility rate to avoid muddying the waters.** Regardless, there's no reason for the ECB to subsidize bank funding in hopes that banks pass through the discount to their borrowers. Bank credit to the real economy is growing at a 5% annualized clip, exceeding nominal GDP growth by more than a percentage point. Not to mention that bank profitability isn't a problem these days. Since the ECB rate hike cycle of 2022-2023, Eurozone bank stocks have been (among) the best performing sector(s). Price-book ratios have returned to a healthy 1.6. During the negative rate era they languished around 0.5.

Italian banks splurging

- **According to the ECB's disaggregated balance sheet, Eurosystem lending to Italian banks has remained rather modest despite ever-lower reserve levels in Italy.** At the end of July, banks in Italy had borrowed 19 billion euros from the Bank of Italy, up from 13 billion euros at the start of the month and representing more than half of outstanding Eurosystem lending;
- **However, in subsequent weeks total Eurosystem lending fell gradually below 30 billion euros.** Since the uptick in lending was driven by Italian banks, I assume they have subsequently reduced borrowing;

Disaggregated financial statement of the Eurosystem[1]

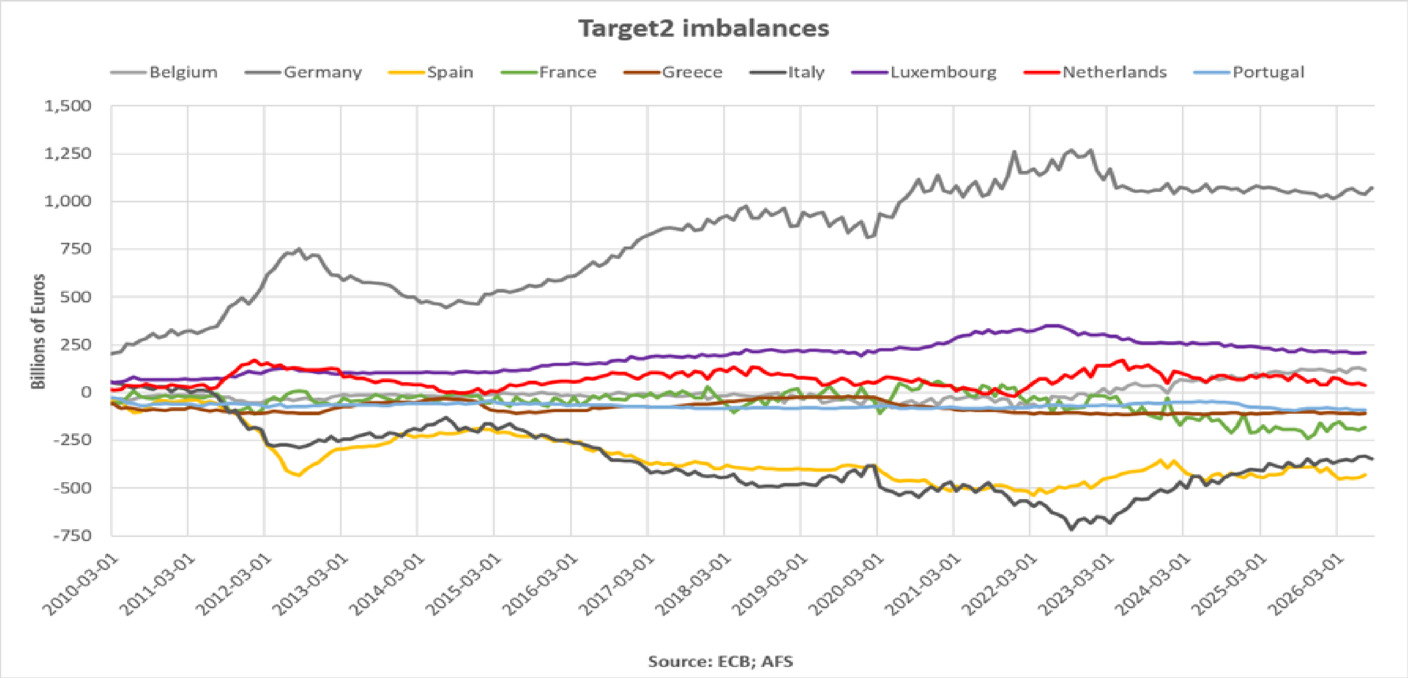
Reference Date:	31.07.2026
Denomination:	EUR millions

[1] For further information on the figures presented in this table please refer to the explanatory note

Assets	Germany	Greece	Spain	France	Italy	Total Eurosystem
1 Gold and gold receivables	380,732	17,341	32,011	277,027	278,713	1,232,856
2 Claims on non-euro area residents denominated in foreign currency	89,977	6,455	76,161	74,611	82,955	524,673
2.1 Receivables from the IMF	55,565	3,302	19,807	45,696	32,701	231,359
2.2 Balances with banks and security investments, external loans and other external assets	34,412	3,153	56,354	28,916	50,255	293,315
3 Claims on euro area residents denominated in foreign currency	3	178	5,491	5,014	1,997	19,722
4 Claims on non-euro area residents denominated in euro	0	177	1,759	14,981	2,141	40,320
4.1 Balances with banks, security investments and loans	0	177	1,759	14,981	2,141	40,320
4.2 Claims arising from the credit facility under ERM II	0	0	0	0	0	0
5 Lending to euro area credit institutions related to monetary policy operations denominated in	11,153	3,450	182	100	19,162	36,229
5.1 Main refinancing operations	6,211	2,450	20	50	12,111	21,939
5.2 Longer-term refinancing operations	4,932	1,000	162	50	7,051	14,230

The Italian Target2 miracle

- **When it comes to liquidity problems, you might say that I am the boy who cried wolf.** Since early 2024, I've been warning about reserve shortfalls in Italy and France and now Italy again. While I have not claimed that French banks will start splurging on LTROs/MROs, I had expected Italian banks would have borrowed tens of billion euros more by now;
- **What has surprised me, is the decline in Italian Target2 liabilities.** Italian Target2 liabilities have fallen strongly since Meloni came to power in the autumn of 2022 (more Euroskeptic types blame the reversal on Italian Target2 liabilities on the ECB's freewheeling spread control tool TPI). For every one euro decrease in the Bank of Italy's Target2 liabilities, bank reserves in Italy rise by the same amount while they fall by the same amount in the rest of the Euro Area;
- **As the Target2 balances charts show, since 2022 banks in Germany**, the Netherlands, Luxembourg, and – for some time – France, were on the losing end.



Foreigners splurged on BTPs

- **Italy's balance of payments data show that hot money inflows drove the decline in Target2 liabilities.** The snippet below from the Bank of Italy's balance of payments release show 109 billion euros in inflows (sum of A through D), which was only partially offset by 66 billion euros in Italian portfolio investment abroad.

Changes in the TARGET balance in relation to the other Balance of payments items

(millions of euros)

	Change in TARGET balance (A)+(B)+(C)+(D)+(E)+(F)-(G)	Foreign portfolio investment in Italian government bonds (A)	Foreign portfolio investment in Italian private sector securities (excl. bank bonds) (B)	Foreign portfolio investment in Italian bank bonds (C)	Resident MFIs other than central bank' net foreign funding (D)	*of which:* cleared through resident central counterparty	Balance on current account and capital account (E)	Other items (direct investment, financial derivatives, other investment residual items, official reserves, errors and omissions) (F)	Italian portfolio investment in foreign securities (G)
2023	163,435	31,097	26,772	16,342	82,679	3,471	21,908	35,057	50,421
2024	104,952	124,339	27,920	12,011	-30,931	-21,047	24,388	33,526	86,302
2025	57,562	111,196	26,016	7,106	-1,847	-24,491	28,935	-2,827	111,018
2024 - 2nd qtr	15,635	28,789	8,563	3,353	-16,907	-4,690	6,820	-6,079	8,902
3rd "...	38,878	23,141	7,169	-104	-582	1,469	9,863	29,704	30,313
4th "...	30,486	30,143	5,370	3,926	-17,256	-7,300	6,031	24,223	21,951
2025 - 1st qtr..	7,411	27,544	9,043	882	7,753	37	-2,913	1,413	36,311
2nd "...	14,331	56,751	5,360	2,903	-19,245	-13,826	10,000	-19,148	22,290
3rd "...	11,474	2,065	5,572	1,262	8,422	-1,453	12,421	16,153	34,422
4th "...	24,345	24,837	6,041	2,059	1,222	-9,249	9,428	-1,247	17,996
2026 - 1st qtr..	1,700	29,791	3,536	5,065	18,746	18,565	3,213	-19,636	39,015
2nd "...	21,023	(53,669)	(11,554)	(11,636)	(-24,986)	(-7,288)	(9,796)	(-13,382)	(27,264)

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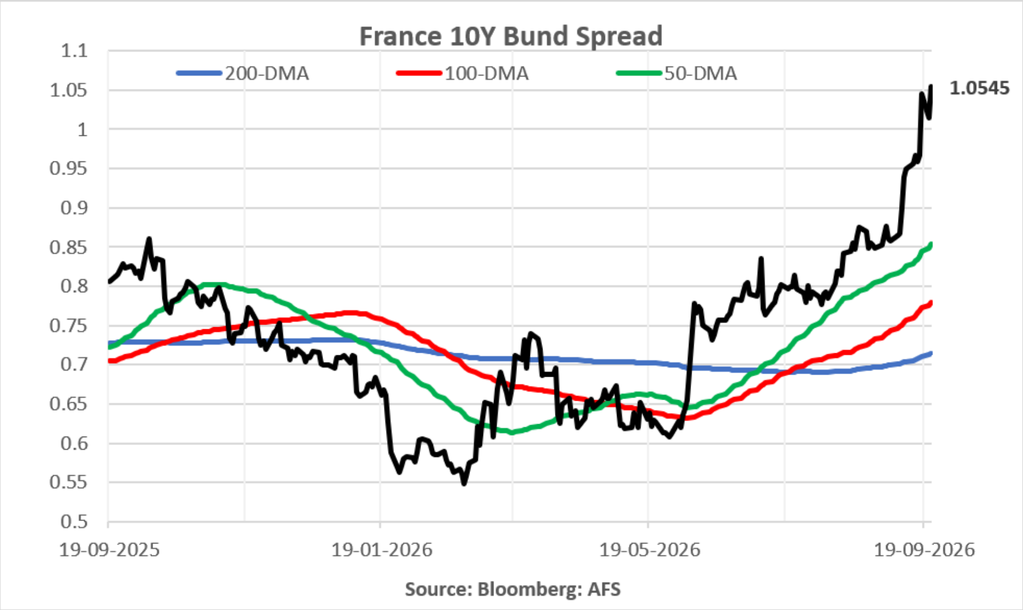
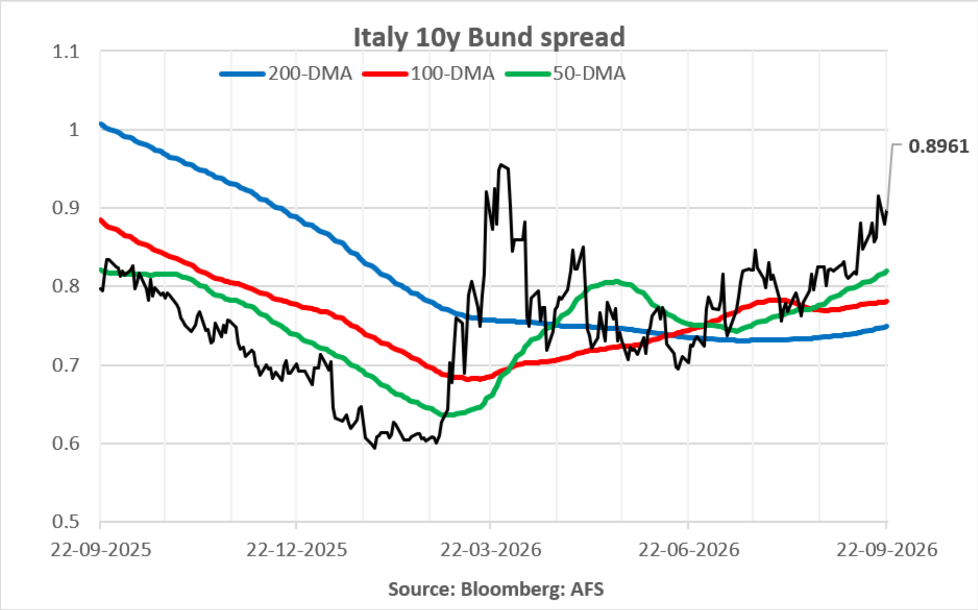
All miracles come to an end

- **Going forward, further decreases in Italian Target2 liabilities are unlikely. For a while at least.** OAT-Bund spread widening has also widened the BTP-Bund spread while leaving the Spanish and Portuguese equivalents mostly unaffected;
- **French elections and the 2027 budget are on market's radar.** French political risk that has also drawn attention to Italian political risk. Italy must hold general elections before December 2027. Polls suggest that Prime Minister Meloni's far right Brothers of Italy party is hemorrhaging support to a new upstart party even further to the right;
- **Concurringly, with ongoing ECB QT and corresponding reserve destruction, Italian banks must either borrow from abroad or the Eurosystem in the coming quarter.** I see no other way.





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