Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

Le Collateral

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Lorcan Roche Kelly

Altruism or desperation? French banks just listed 8,067 new instruments with the ECB.

At the December ECB monetary policy meeting President Mario Draghi announced two major measures to ease funding pressure in the Euro area banking system (see "On the ECB Monetary Policy Decisions" December 8, 2011).

- First was offering Longer-Term Refinancing Operations on a 3-year, fixed rate, full allotment basis. We saw the result of that when demand for the first 3-year LTRO came in far ahead of expectations (see "Europe's Wall of Liquidity" December 21, 2011), with €489 billion extra liquidity provided. At the time we thought that much of the new liquidity would be deposited back at the ECB, and this has certainly proven to be the case, with deposits currently at record highs of €455 billion.
- Now the ECB's second major policy initiative is starting to have an effect, too -- to loosen eligibility criteria for collateral, thus increasing the number of instruments that would be available for banks to use as collateral, even to the level of individual credit claims (again, see "On the ECB Monetary Policy Decisions"). This week, the ECB's eligible list contains 39,812 instruments -- a jump of over 36% from the last week of 2011. By checking the daily updates by the ECB, we find that nearly all of the over 10,500 new instruments were added in the end of day update on December 30 -- the last update of 2011. 8,067 of the new instruments, the vast majority, were added at the request of French banks (please see the charts on the following page).

The increase in eligible instruments added by French banks can be viewed two ways:

- **It is bad.** This massive increase in collateral available to French banks -- and each instrument added to the collateral list is a demand-led event -- means that French banks are not going to be able to fund themselves in the market in the coming year, and they know this, so they are making contingencies.
- **It is good.** The ECB changes in collateral rules means that French banks now have access to much more liquidity from the ECB. This

Update to strategic view

EUROPE FINANCIAL STOCKS, ECB: French banks added an incredible 8,067 new instruments to the list eligible for ECB liquidity operations. On the surface it seems like this is just the banks positioning themselves to take advantage of the looser collateral requirements from the ECB, and in turn use the liquidity to purchase sovereign debt. However, French banks have their own funding problems in 2012, and adding so many instruments may be kitchen-sinking to make every penny available.

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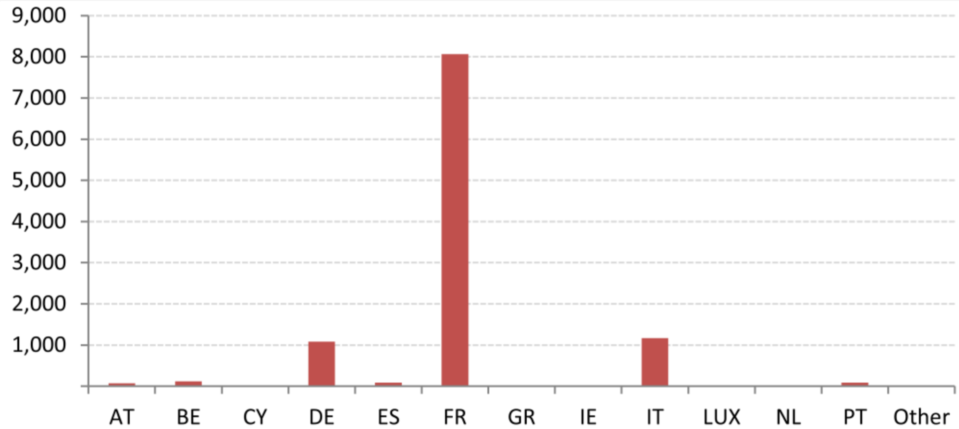
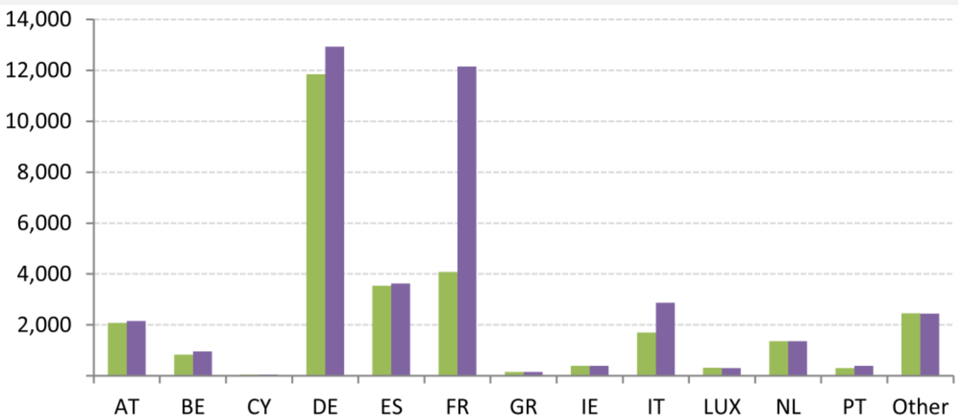
means that if they are not able to fund themselves in the market, they have plenty of scope to fall back to the ECB.

- So this development has the same pattern as any "bail-out" operation -- it's a bad thing that it is necessary, but a good thing that it is available.

Instruments added to ECB eligible collateral list at year-end, by country



Instruments on ECB eligible collateral list, by country 12/28/11 1/3/12



Source: ECB, TrendMacro calculations

In the same vein, in the last week of the year much of the dour tone in world markets was set by the news that the ECB's balance sheet had risen to a near-record size in the wake of the first 3-year LTRO -- indicating the extraordinary need for liquidity. This struck us as odd, given that the results of the auction had been known the prior week, and given that it represents the utilization of a safety valve that can protect both Europe's banks and Europe's sovereign debt markets (again, see "Europe's Wall of Liquidity" and "Saved by an Acronym" November 30, 2011).

- We expect even more uptake of 3-year LTRO liquidity at the next operation on February 28. At the time of the first operation we knew from banking sources that banks were not ready to take full advantage of the newly loosened collateral rules (again, see

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

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"Europe's Wall of Liquidity"). With more than 10,000 new instruments already added to the eligible list, LTRO liquidity will surely move to new highs.

- It is important to note that even though these instruments were added to the list of eligible collateral on December 30, it is unlikely that they have been used for any regular ECB operations yet.
- The weekly Main Refinancing Operation for the first week in January -- the first these instruments have been eligible for -- actually showed a drop of €15 billion to €130 billion from the previous week's total.
- It seems the French banks are keeping their powder dry for the next 3-year LTRO. This would make sense if they are planning to use this collateral to allow them to fund sovereign debt purchases via the ECB LTRO -- a maneuver we identified as soon as the 3-year LTRO was announced, which is now known widely in the market as the "Sarkozy trade."
- If this is the plan, then sovereign debt roll-overs should not be a problem in 2012 -- for France, at least.
- However, we are already aware that French banks are having difficulties raising funds, and with €37 billion of debt payments due in the first quarter of 2012, the reason for these additions to the ECB's eligible list may be less altruistic.

Bottom line

French banks added an incredible 8,067 new instruments to the list eligible for ECB liquidity operations. On the surface it seems like this is just the banks positioning themselves to take advantage of the looser collateral requirements from the ECB, and in turn use the liquidity to purchase sovereign debt. However, French banks have their own funding problems in 2012, and adding so many instruments may be kitchen-sinking to make every penny available.