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MACROCOSM

ECB: It Takes Whatever

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The euro sovereign carry trade turns out to be a myth. SME credit is where the pressure is.

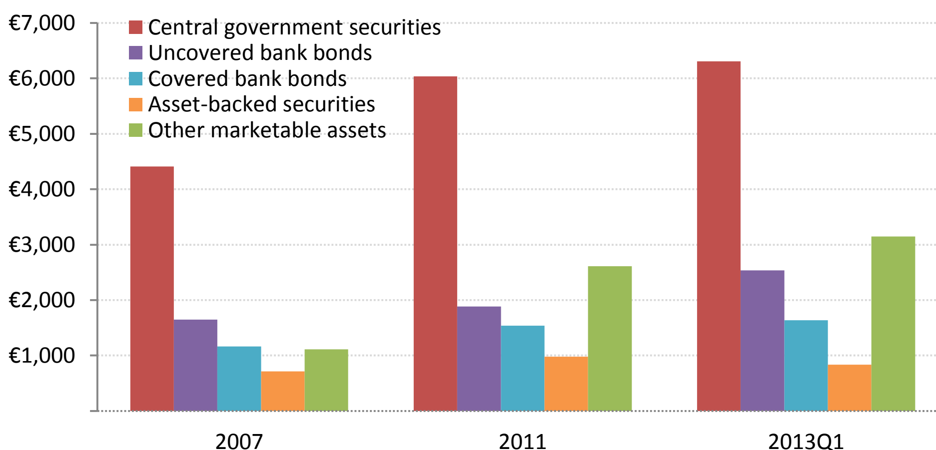
The ECB's two 3-year longer term refinancing operations (LTROs) in December 2011 and February 2012 (see "LTROphoria" February 27, 2012) are widely believed to have caused significant rallies in peripheral euro area sovereign debt. The argument has been that banks would use the LTROs to fund a carry trade, buying sovereign bonds yielding over 5% and repo-ing them at the ECB at the base rate -- currently 0.5%.

Now, ECB President Mario Draghi's recent announcement that the ECB will continue to run fixed-rate full-allocation operations until July 2014 -- at the earliest -- would seem to mean that even banks that missed the 3-year LTRO carry trade opportunity can now buy peripheral debt with confidence (see "On the May ECB Policy Decision" May 2, 2013).

But there is little evidence in the data that this carry trade has actually happened to any great extent. Euro area banks are using non-marketable assets -- such as credit claims -- more than sovereign bonds as collateral.

- True, at €6.3 trillion the plurality of the €14.5 trillion of eligible collateral at the ECB are sovereigns (please see the chart below).

Value of assets available as collateral EUR billions



Source: ECB, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: Data from the ECB shows that the peripheral sovereign debt carry trade -- taking advantage of high sovereign yields and low ECB rates under the 3-year LTROS -- doesn't actually exist. Instead, non-marketable assets backed by credit claims are now the largest, by value, of actively used collateral. This demonstrates where the real choke-point in the euro area is -- not with sovereigns, but with small and medium-sized enterprises. The ECB's initiatives to reinvigorate the market for SME credit is a reflection of this reality.

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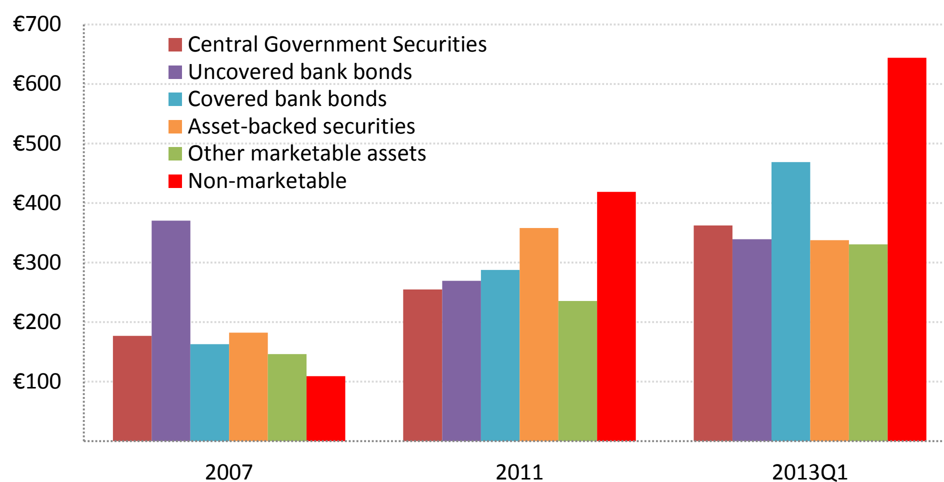
It is important to note that the €14.5 trillion total only includes marketable instruments.

- But only a tiny proportion of these sovereign bonds -- €362.5 billion -- are actually being used as collateral (please see the chart below).
- Currently the most popular type of collateral for banks is one that is not included in the €14.5 trillion total at all -- non-market instruments (again, please see the chart below).

Value of collateral in use After haircut, EUR billions



Source: ECB, TrendMacro calculations
NOTE: The total of collateral used exceeds by over 100% the amount of outstanding ECB credit due to the way that banks post collateral with NCBs, which is done under a pooling protocol that generally leads to excess collateral in the system.

- Draghi famously said "whatever it takes" (see "On Draghi in London" July 26, 2012). Now, looking at the extent of non-market instruments against which the ECB is lending, it turns out that the ECB takes *whatever*!

These non-market instruments fall into two very different categories.

First, there are fixed deposits. Basically, this refers to the fixed-term deposits the ECB collects weekly to "sterilize" the ECB's purchases under the Securities Markets Programme (SMP).

- This means that if a bank has a deposit in the fixed-term operation, it can use that deposit as collateral for a liquidity operation.
- At first blush, this arrangement appears to make no sense: why would a bank deposit cash at the ECB at 0% and then borrow from the at 0.5%? But the ECB has told us that these deposits are used as collateral for intra-day liquidity from the ECB, which carries no interest charge.
- Currently, €171.7 billion of fixed deposits are actively used as collateral. Whatever else this means, it seems to make a bit of a mockery of the "sterilization" function of those fixed-term deposits.

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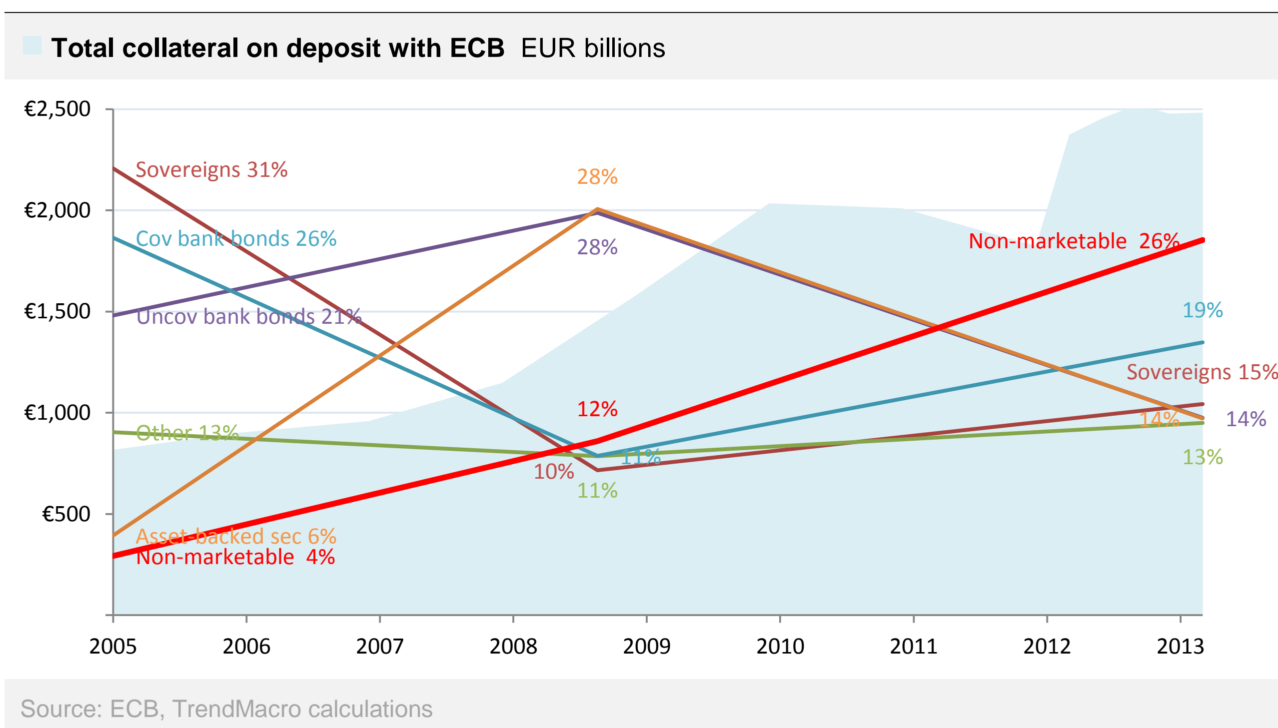
The second type of asset that falls under non-market instruments is credit claims.

- In [December 2011] the ECB announced that "NCBs are allowed, as a temporary solution, to accept as collateral for Eurosystem credit operations additional performing credit claims."
- This announcement was followed [in February 2012] with another one that approved the use of credit claims as collateral with certain central banks, namely:
    - Central Bank of Ireland
    - Banco de España
    - Banque de France
    - Banca d'Italia
    - Central Bank of Cyprus
    - Banco de Portugal
    - Oesterreichische Nationalbank
- The Bank of Greece was added to the list in [July 2012].
- Because these credit claims are non-market instruments, it is impossible to get an idea of the original value of these assets -- the ECB only provides post-haircut valuations.
- Latest [data shows] that post-haircut €472.5 billion of credit claims were actively being used as collateral at the end of Q1 2013.

If we chart the data on all collateral types, we can clearly see the evolution of these non-market instruments as the leading form of collateral at the ECB (please see the chart below).

So what does all this mean, and why is it important?

- Draghi has recently been pushing for the development of a market



Total collateral on deposit with ECB EUR billions

Source: ECB, TrendMacro calculations

in collateralized small- and medium-size enterprise (SME) credits (again, see "On the May ECB Policy Decision").

- The massive increase in the use of credit claims as collateral, and the clear preference for it by banks in the periphery -- and France -- shows where the real credit stress in the euro area is.
- This has led to the ECB's current initiatives to try to address this pinch-point in the monetary policy transmission mechanism -- initiatives such as those outlined by Draghi, with ECB board member Erkki Liikanen even saying recently that outright purchases by the ECB are on the table.

Whatever the eventual outcome, comments from the ECB -- and the data -- show that, despite impressions, ECB liquidity is not directly driving sovereign bond yields. Rather it is the conduit, without which SME credit in the periphery -- and France -- would be under even deeper stress than it currently is.

- And that leaves an intriguing question: if the carry trade enabled by ECB liquidity hasn't been the driver behind the rally in sovereign debt, what has been?
- Surely the 3-year LTROs gave the market assurance that euro area banks would not face funding risk for a very long time. Taking that pressure off the banks took pressure off the sovereigns, by ruling out an illiquidity-driven systemic banking failure requiring expensive rescues.
- And Draghi's "whatever it takes" speech in London almost one year ago, though providing no liquidity to the market -- indeed, leading no actual action by the ECB whatsoever! -- was a credible put-option under sovereign debt (again, see "On Draghi in London").
- And -- dare we say it? -- maybe the sovereigns have helped themselves here by following through on structural reforms more reliably than skeptical markets ever expected in 2011 and 2012 (see "Restructuring Austerity" May 9, 2013).

Bottom line

Data from the ECB shows that the peripheral sovereign debt carry trade -- taking advantage of high sovereign yields and low ECB rates under the 3-year LTROS -- doesn't actually exist. Instead, non-marketable assets backed by credit claims are now the largest, by value, of actively used collateral. This demonstrates where the real choke-point in the euro area is -- not with sovereigns, but with small and medium-sized enterprises. The ECB's initiatives to reinvigorate the market for SME credit is a reflection of this reality.