European Rates Watch

BoE reserves: Preferred minimum closer than you think

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Rates Research
Europe

European Rates Research
MLI (UK)

Agne Stengeryte, CFA
Rates Strategist
MLI (UK)
agne.stengeryte@bofa.com

Alastair Ryan >>
Research Analyst
MLI (UK)
alastair.ryan@bofa.com

See Team Page for List of Analysts

Bank of England reserves to decline in 2024-2025...

We forecast the Bank of England (BoE) balance sheet to drop by slightly over £100bn in 2024 and £200bn in 2025. On the asset side, we assume BoE's Quantitative Tightening (QT) will amount to £100bn per year. The roll-off of the Term Funding Scheme with additional incentives for SMEs (TFSME) will have an increasingly meaningful role into 2025. We do not assume early TFSME repayments. Risks therefore skew to earlier balance sheet drop. On the liability side, the decline will be reflected in the fall in Bank reserves (Exhibit 1 and Exhibit 2).

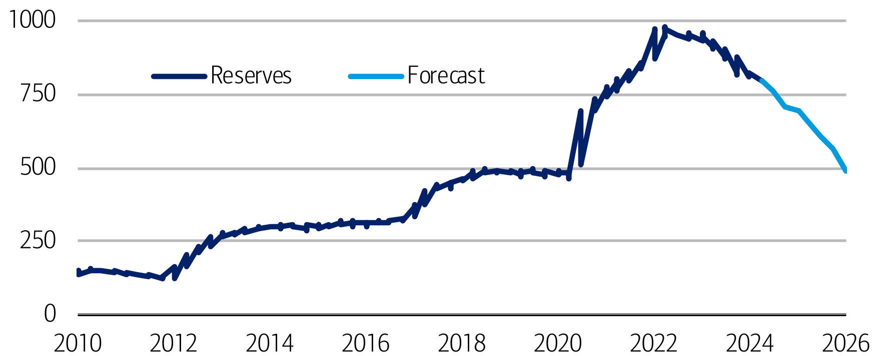
... amid the backdrop of declining global liquidity

The decline in BoE reserves in 2024-2025 will occur against the backdrop of declining global liquidity. In Global central bank balance sheets section of the Global Rates Year Ahead, 19 Nov, we forecast the collective central bank balance sheet in the US, Euro area, UK, Japan, Australia, and Canada to fall by USD1.5trn in 2024 (Exhibit 3). Excess liquidity changes are forecast to track balance sheet changes very closely but not necessarily one-for-one, with any differences reflecting additional expected shifts between central bank liabilities such as government deposits and banknotes.

Preferred Minimum Range of Reserves on the horizon

BoE's latest estimate of aggregate Preferred Minimum Range of Reserves (PMRR) is £335-495bn (Hauser, 3 Nov), not far from where we estimate reserves will be by late 2025.

Exhibit 1: BoE reserves incl. BofA forecast, £bn
TFSME roll-off to accelerate reserves drop in 2025



Source: Bank of England, BofA Global Research

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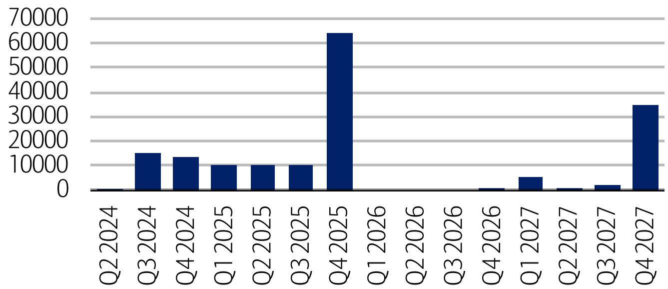
Timestamp: 07 December 2023 07:18AM EST

To test where the true PMRR might be, the Bank has introduced a weekly Short-Term Repo (STR) offering unlimited reserves against Gilt collateral at Bank Rate. BoE's goal for STR is to allow the Monetary Policy Committee (MPC) to focus solely on monetary policy considerations in setting its strategy for Asset Purchase Facility (APF) unwind, without concern for the Bank's ability to align short-term market interest rates close to Bank Rate. For now, the Bank intends the STR to be used freely. Close monitoring of STR in 2024 will help get a sense around PMRR.

Exhibit 2: Our assumed TFSME repayment schedule, £mn
TFSME roll-off to reduce BoE balance sheet in 2024 and 2025



Source: Bank of England, BofA Global Research
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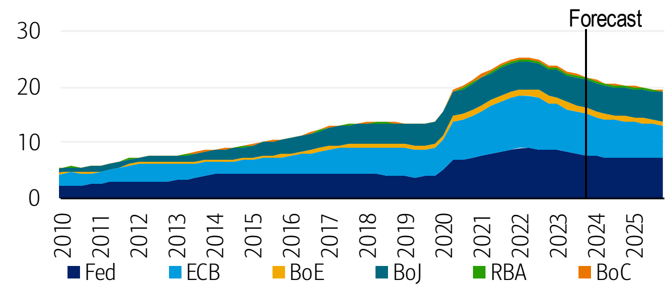
Exhibit 3: Aggregate G-6 central bank balance sheet, USDtrn
Aggregate balance sheet to continue falling



Source: BofA Global Research, Bloomberg. USD values based on spot exchange rate.
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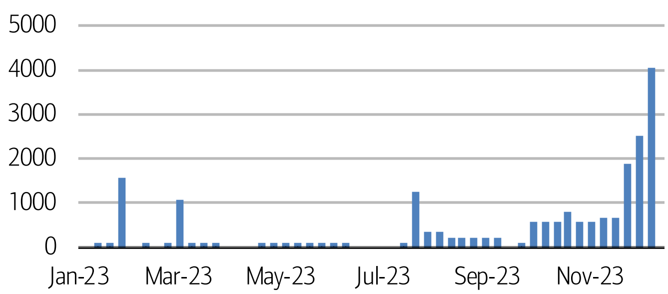
First signs of STR in action

According to the latest BoE STR usage data, 4bn was borrowed in the week commencing 7 Dec against high quality Level A collateral at Bank rate (Exhibit 4). In the week prior, the borrowing was £2.5bn – also meaningfully above the £0.5bn/week on average since late September. The increase in STR borrowing coincided with cheapening of repo relative to Bank rate, with Repurchase Overnight Index Average (Ronia) spread to Bank rate briefly exceeding 8bp on 30 Nov (Exhibit 5). Pick up in STR operations as repo cheapened indicates dissipating cash/collateral imbalance. Under current framework, funding pressures may have more limited impact in the UK relative to Europe given more attractive pricing, we think. For more on EUR, see [Running into a wall, 8 Nov](#).

Exhibit 4: BoE STR facility usage, £mn
Higher usage lately...



Source: Bank of England, BofA Global Research
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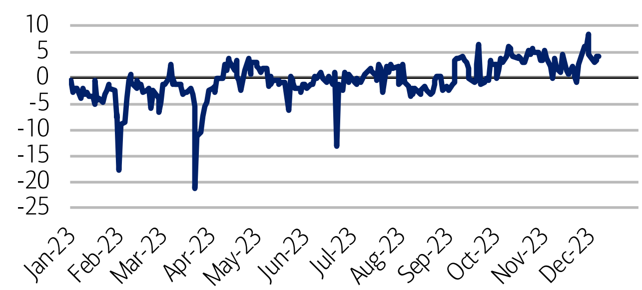
Exhibit 5: Ronia vs. Bank rate spread, bp
... corresponded to Ronia cheapening vs. Bank rate



Source: Bloomberg, BofA Global Research
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Bank analysts' deep dive into central bank balance sheets

> Below is an excerpt from European Banks Strategy report Year Ahead 2024: calm and re-rating (28 Nov).

A few trillions of euros are sloshing around the financial system. This is one of the big uncertainties for 2024, we think. Good policy offers cheap solutions; bad policy can generate financial market breakage. And while we conclude banks are resilient to most outcomes, bank stocks don't tend to do well during any financial stress.

The story for bank analysts in Europe and the UK is the following:

- Banks are more liquid than ever, but bank demand for reserves will conflict with central banks' desire for a smaller balance sheet and easier financial conditions, possibly already in 2024.

- Central banks could ease the strain through including bank collateral in their liquidity metrics, or through pushing for lower Liquidity Coverage Ratios (LCR). No sign yet of either. And without that, we worry a policy mistake is upcoming.

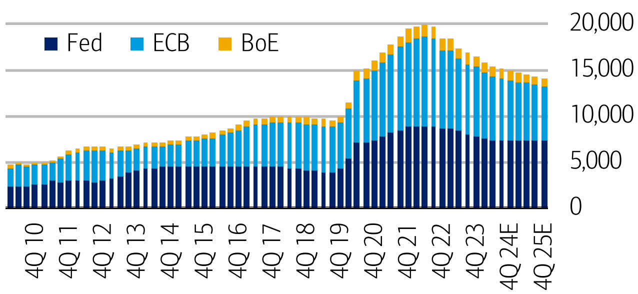
- The mandatory reserves discussion could compound the error in Europe, while diminishing central banks' most valuable currency, their credibility.

Central banks: the urge to shrink

A US$15 trillion expansion in US and European central bank assets in the era of "no inflation" is being rapidly reversed (Exhibit 6). The way bank regulation – including the LCR – interacts with central bank shrinkage could be the source of trouble.

It is symmetrical for central banks to be seeking to reduce their scale while tightening monetary policy, but it is worth noting that the transmission mechanism has worked very well with big balance sheets: Exhibit 7 shows that loan rates have moved in line with higher ECB policy rates, for what the ECB characterises as "strong" transmission.

Exhibit 6: Western central banks rapidly shrinking
Federal Reserve, ECB and Bank of England total assets (US$ bn) 2010-25E



Source: BofA Global Research, Bloomberg

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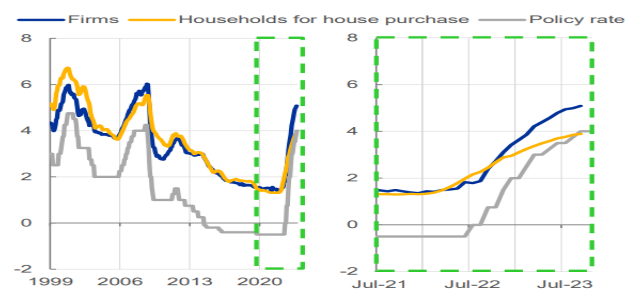
Exhibit 7: Composite cost of borrowing (%) 1999-2023
"Strong transmission of monetary policy to funding costs and bank lending"



Source: ECB, Schnabel

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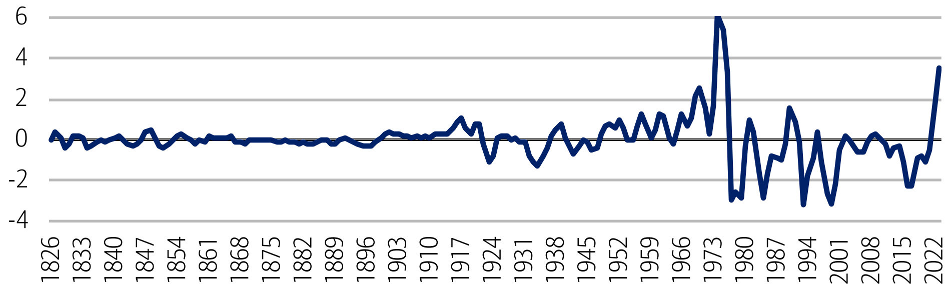
The size of the central bank balance sheet does not seem to have been an impediment to monetary tightening. Central banks have low confidence of how much of the rate hikes have been experienced by the economy. Perhaps less, as corporates are better funded and the rate shock lies ahead. Perhaps more, if the lack of residential mortgage stress means consumers just do not behave in a recessionary way this time.

Why then, introduce a further complexity by trying to shrink balance sheet at the same time? But current policy is strongly focused on reduction. We see the ECB and the BoE looking to reduce their balance sheet by more than US$2 trillion over 2024E and 2025E

So far, the reduction has only been associated with two "shocks": the UK Gilt market collapse in September 2022 and much higher bond yields. After the BoE won its battle with HM Treasury and the UK government was changed, Gilt market functioning was restored and Quantitative Tightening (QT) has proceeded "smoothly" according to the BoE, if the largest back-up in yields since 1975 is considered smooth (Exhibit 8).

Exhibit 8: three-year cumulative change in Gilt yields largest since 1975
Gilt yields, three year rolling change, 1823-2023 (%)



Source: BofA Global Research estimates, Bank of England

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Spinning wheels

Tightening was originally sequenced at both the ECB and the BoE: Quantitative Easing (QE) had to stop before rates could be hiked. Now, it seems quite possible that in 2024, the ECB will be cutting rates while shrinking the balance sheet quickly. We expect the Eurosystem's balance sheet to fall by €820bn in 2024 and €540bn in 2025 and the ECB to cut rates from June 2024.

We forecast the BoE balance sheet to drop by £100bn in 2024 and £200bn in 2025, with QT £100bn per year and the roll-off of the TFSME additional in 2025. It's less likely the BOE will be cutting rates, as UK inflation is more entrenched, but the potential for this accelerating with the handbrake on is present in the UK too.

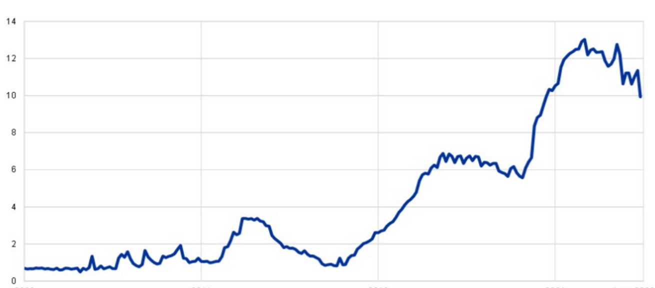
LCR and QE together and inseparable

One of the main pillars of Basel III post the financial crisis was the LCR. Announced as a goal in 2011 and first binding in 2015, it has absorbed trillions in liquidity need.

European banks had an 70% LCR as of mid-2011, which meant a shortfall of liquid assets of €1.15tn, according to the European Banking Authority (EBA). Quantity and quality were both lacking against the new rules. Banks rapidly built their HQLA: from 60% LCR required in 2015 to 100% in 2019, the banks accelerated through to 161%.

Looking at HQLA reserves component (deposits by banks with the ECB), Exhibit 9 shows what we think is a very clear picture. The LCR drove a massive increase in bank demand for cash. It's important that the industry has shown very little appetite to run down its cash position even as the ECB has started shrinking its balance sheet (Exhibit 10).

Exhibit 9: Euro area bank reserves to total assets, %, 2006-23
Bank reserves to assets rose sixfold 2015-19



Source: ECB, Lane

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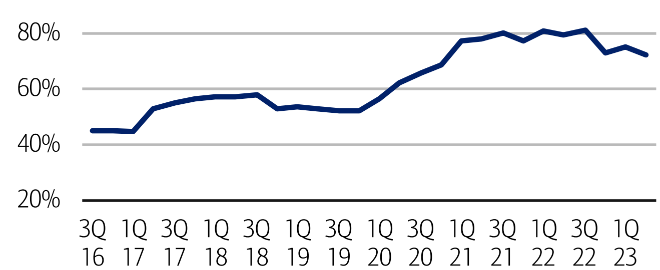
Exhibit 10: Euro area bank cash position, % HQLA, 2016-23 (%)
Banks have a strong cash preference within HQLA



Source: BofA Global Research, ECB

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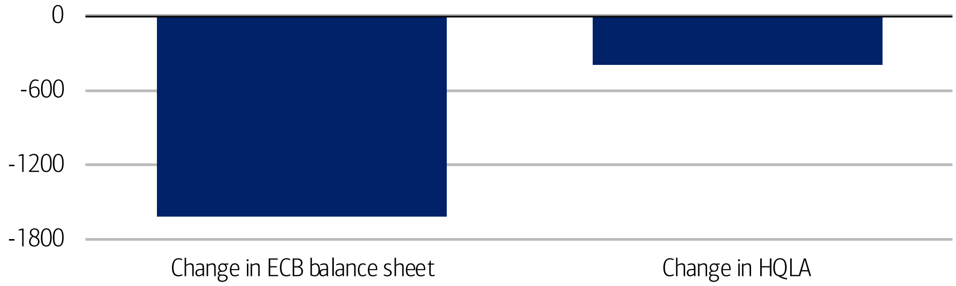
Government bonds are a part substitute for cash

Banks could substitute government bonds for cash in their HQLA. But bonds have price risk and market haircuts. The ECB may charge up to a 13% haircut; the market may charge more. Bonds also consume stress capital, banks having to include the possibility of falling prices in their stress test. Overall, a strong preference for maintaining record levels of cash-dominated HQLA is clear, we think (Exhibit 11).

Exhibit 11: HQLA decline in the euro area only a quarter of the reduction in the ECB's balance sheet
Change from peak, € mn, ECB total assets and euro area bank HQLA



Source: BofA Global Research estimates, ECB

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Double demands

A key of the LCR is it is calculated on assets that can be sold into the private market:

> The LCR promotes the short-term resilience of a bank's liquidity risk profile. It does this by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs
>
> *Basel Committee 2013*

Central banks chose to exclude eligible assets

However, this is also in some ways peculiar. A key function of Central Banks is to provide liquidity insurance to the banking system. The LCR ignores this. The implications are highly significant for the central banks' own balance sheets – they have to be much bigger. Some examples serve to illustrate:

- **Nationwide:** A recent announcement – in November 2023, the UK's Nationwide Building Society reported a 141% LCR, net of Term Funding Scheme financing liquidity. This was driven by its £53bn of HQLA. But it disclosed a further £75bn in central bank drawdown capacity, which does not feature.
- **HSBC:** Among listed banks, HSBC is always an extreme, given its low loan/deposit ratio and historical focus on remaining exceptionally liquid, but the US$1 trillion in potential liquidity it could generate from its assets, pre-haircuts would illustrate how poor a benchmark the LCR is.
- **Bank of Ireland:** At the end of 2022, Bank of Ireland had a 221% LCR, based on HQLA of €38bn – almost entirely cash at central banks. But it had multiple sources of potential liquidity:
    1. Retained covered bonds - we estimate a 20% typical ECB haircut on this readily available collateral,
    2. Other mortgages likely eligible for ECB or BoE refinancing - with less certainty over timing and quality, we assume a 40% haircut.
    3. Other loans such as corporate exposure - the ECB has facilities to accept these loans, but we assume a high discount for them. In the

round, Bank of Ireland's "real" liquidity access might reasonably be considered double that of its reported level.

Putting these examples together, we are struck by two compounding factors:

1. **Banks are choosing a 30-60 point LCR surplus:** Banks are choosing an LCR vastly in excess of their 'required' LCR of 100%. In the EA alone, this represents €2 trillion of 'lost' liquidity. Regulatory, supervisory, rating agency, counterparty and market expectations have built this surplus into banks' planning.
2. **Trillions of potential liquidity not considered:** Banks then likely have several trillion euro of potential liquidity embedded in their loan books. This receives no external credit, even though it is included in the banks' internal planning with the ECB, Bank of England and so on.

Choices, choices

The ECB and BoE *could* change this strong preference for cash holdings, in multiple ways:

- Central banks could emphasise that they do not value banks hoarding LCR. Currently, the opposite is true: a high LCR is held up as evidence of the system's strength:

> Banks' liquidity situation remained strong, with an average liquidity coverage ratio of 158%.
>
> *Andrea Enria, November 2023*

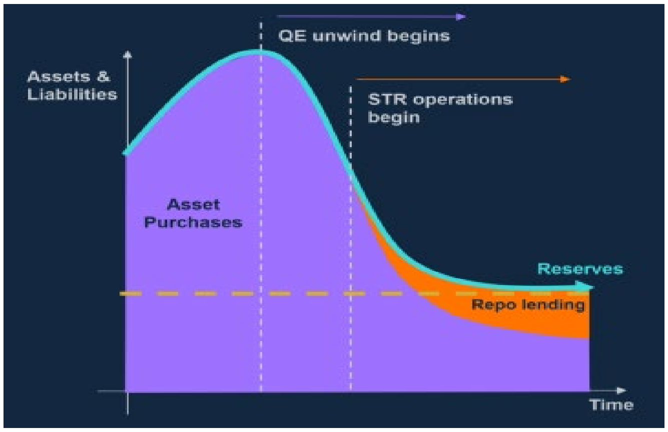
- They could emphasise the amount of potential liquidity they know is available to the banks through their repo-eligible assets;
- They could create a repo facility that is clearly available to banks without stigma. The ECB Chief Economist recently discussed this, but it looks like very early stages.

The BoE *does* have a repo facility now, the STR, which it intends to be a non-stigmatised funding option and is available at Bank Rate. Quote below from a recent speech by Andrew Hauser, seeks to emphasise that at least from his point of view, banks can be expected to use the facility structurally in the future. Where does this bite? The BoE is far from sure: its latest estimate of UK banks' PMRR is high:

> One obvious way to get a handle on banks' PMRRs is simply to ask them – and we run a twice-yearly survey to do just that. The latest aggregate PMRR estimate from this exercise is £335-495bn.
>
> *Bank of England, November 2023*

The high end of this range has doubled since 2021, as shown in Exhibit 13 and the BoE is clear that the LCR creates an even larger figure, of £570bn, some of which is currently filled with other HQLA.

Exhibit 12: stylised path for UK bank reserves and repo
As the BoE reduces its assets, it expects banks to use repo funding



Source: Bank of England

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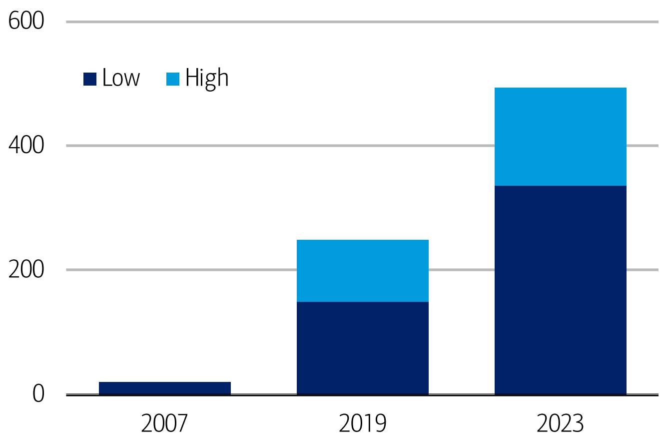
Exhibit 13: BoE estimate of banks' reserve demand since 2019, £bn
Banks' reserve demand has doubled since 2019



Source: Bank of England, Hauser

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A €3.5 trillion euro-area equivalent choice

The Swiss have also been active in balance sheet reduction and the necessary conclusions. The Swiss National Bank (SNB) implemented a repo and bond programme in 2022. This was quickly a CHF200bn balance sheet liability for the SNB, or 25% of GDP.

And as the Swiss National bank says:

> One possible measure to mitigate this stigma issue is to try to make liquidity assistance commonplace. The hope then is that receiving liquidity support loses its stigma if liquidity is obtained by banks on a regular basis rather than only being available in an emergency. Yet it is clear that obtaining large amounts of liquidity will always sound alarm bells – even if it is not called 'emergency' assistance. Stigma will therefore not be resolved simply by renaming liquidity assistance.
>
> *Swiss National Bank, November 2023*

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Research Analysts

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
ralf.preusser@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
sphia.salim@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
mark.capleton@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
ronald.man@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
erjon.satko@bofa.com

Agne Stengeryte, CFA
Rates Strategist
MLI (UK)
agne.stengeryte@bofa.com