European Rates Watch

ECB active QT: first cost estimates

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Rates Research
Europe

European Rates Research
MLI (UK)

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
+33 1 8770 0304
erjon.satko@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

ECB focused on cost minimisation

At its July meeting, the ECB decided to lower the remuneration of banks' reserve requirements from Depo rate, to 0%. We saw this as a clear signal that the ECB is now focused on reducing the costs of its large balance sheet (The ECB's cost minimisation problem). While we argued that this risks damaging the effectiveness of monetary policy, we pointed to three concrete takeaways: (1) the ECB would likely lower the remuneration of government and foreign CB deposits to 0%, (2) it would find it hard to start active QT next year given the losses this would entail, and (3) it is likely that it would stop full PEPP reinvestments before end of '24. On Aug 4th, the Bundesbank announced that it would lower the remuneration of govt deposits it receives, to 0%. The timing surprised us, but the outcome is consistent with (1) – see European Rates Watch. Below, we expand on (2), by estimating the losses that would be crystallised from active QT under different scenarios. These would add to a large negative carry on QE holdings.

ECB APP portfolio end '22 = c.€400bn of unrealised losses

At the end of 2022, the national central banks of Germany, France, Italy, Spain and Holland had a combined APP book value of €2.25tr, vs market value of €1.97tr (Exhibit 1). We estimate that this would imply a market value of €2.85tr for the full APP portfolio, vs a reported book value of €3.25tr, ie unrealised losses of c. €400bn. YTD, Euro bond market returns are close to 1% after 16-19% negative returns in '22. At the same time, quarterly amortisation has taken place. Unrecognised losses may have fallen by c.€35bn.

€100bn Active QT in '24 may mean crystalizing €12bn loss

Active QT would effectively result in the recognition of mark to market (MtM) losses on bonds being sold. If bond prices stay at current levels, and the ECB sells holdings without differentiating bonds in function of their MtM, we estimate that a €100bn active QT in 2024 (3.5% reduction in APP portfolio) would come with c.€12bn of losses crystalized, while reducing the negative carry by under €2bn in '24 (this annual carry benefit will evolve with changes in remuneration of bank deposits at the ECB, relative to what would have been net income from the bonds sold). The ECB would then run a loss of €66-80bn in '24 (up €10bn from the €56-70bn estimate without active QT – Exhibit 2). Letting PEPP fully roll off from mid '24 would produce around the same balance sheet reduction, with a c.€1bn reduction in the negative carry over 2H24, and no extra losses crystalized.

A return to neutral = another reason to delay active QT

The baseline of rate cuts towards neutral means the ECB will likely assume a lower negative carry on its QE holdings in the future. More importantly, should rates rally with the market repricing neutral lower, from 2.5% towards the ECB's estimate of 2%, the QE portfolio can appreciate, reducing the MtM losses in 2024 & beyond. A €100bn portfolio with 7y average duration would appreciate by c.€3.5bn on a 50bp rally, more than the €2bn of carry benefit that would be recorded by actively selling such a portfolio in 2024.

CB: Central Bank

ECB: European Central Bank

APP: Asset Purchase Programme

PEPP: Pandemic Emergency Purchase Programme

QE: Quantitative Easing

QT: Quantitative Tightening

YTD: Year to Date

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Exhibit 1: Asset Purchase Programme (APP): values at end of 2022

We estimate that the market value of the Eurosystem APP holdings was around €400bn lower than book value at the end of 2022.

	Book value, Dec-22	market value, Dec-22	Difference (Market-Book)
Germany	719	632	-88
France (*)	626	548	-78
Italy	440	393	-46
Spain (*)	326	288	-38
Netherlands	134	115	-20
Sum of the five	2,246	1,975	-270
APP ex supras, est. (**)	2,995	2,635	-360
FR+SP Supras	149	124	-25
Supras, est. (***)	258	214	-44
APP, BofA est. (**)	**3,253**	**2,849**	**-404**

Source: National central banks, BofA Global Research

(*) excluding Supranational, (**)(**) we estimate market value by applying the same market/book value ratio for the overall APP portfolio ex Supras as the one derived from the sum of holdings by the five countries shown (***) we estimate market value by applying the same market/book value for all supra holdings as for holdings by Bank of Spain and Banque de France taken together

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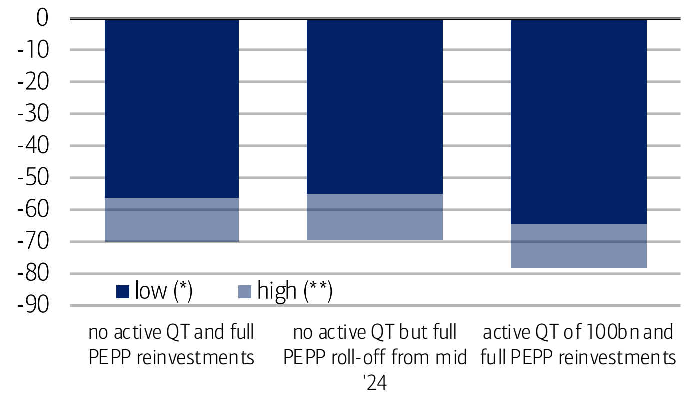
Exhibit 2: BofA estimates of ECB losses in 2024 (***)

Full PEPP rolloff from mid 2024 will only marginally lower the negative carry in 2024, but the reduction in the balance sheet will help further as time goes on. A similar reduction of balance sheet via active APP QT in '24 will result in a net €10bn of extra losses as the ECB sells below book value.



Source: BofA Global Research. (*) no hike in September and a reduction in the remuneration of Govt and foreign CB deposits. (**) hike in September and no change in the remuneration of govt and foreign CB deposits. – see The ECB's cost minimisation problem. (***) Assuming bond prices are stable relative to current levels when the ECB conducts active QT.

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