

## European Rates Watch

# Italy and Spain not out of the woods yet

### Banks still care about good LCR optics...

Euro area banks reported a LCR of 159% in 3Q23, well above the regulatory requirement of 100%. The LCR has been effectively stable over the past year despite the ongoing reserve decline as TLTROs mature and QT by the ECB continues (Exhibit 2). Cash continues to account for most of banks' HQLA portfolio at 72% in 3Q23.

### ... but this will be increasingly difficult to sustain

[We estimate](#) excess liquidity in the euro area will be €2.8trn by end-2024 and bank reserve demand for LCR purposes is between €2.1trn and €3.4trn. This suggests reserve demand in the euro area could exceed supply in 2024, a [key theme](#) for front-end euro rates in 2024 (Exhibit 3).

### Italy and Spain may still need to compete for reserves...

Banks in Italy accumulated sufficient reserves since mid-2023 to repay their TLTROs when they come due. But we believe they may need to accumulate at least a further c. €220bn by end-2024 for LCR purposes (Exhibit 1). Banks in Spain, which also built-up sufficient reserves to repay their TLTROs, may need to attract a further c. €90bn.

### ... and we think lending by banks in Germany may help

A cross country decomposition of 1) banks' estimated reserve demand for LCR purposes, 2) latest excess liquidity level, and 3) projected end-2024 excess liquidity level, suggests banks in Germany – unsurprisingly – may have the most scope to lend to other banks on a cross border basis. By the same measure, banks in France are now much closer to facing a reserve deficit when accounting for LCR-related reserve demand (Exhibit 4).

### Cross border lending stalled in 2H23...

Banks in France pulled back from net cross border lending in 2H 2023, having net lent c. €60bn to banks in Italy in 1H23 (Exhibit 5). And while banks in Italy continued to increase their excess liquidity in 2H23, this was not achieved by lending from other euro area countries, but more through [asset sales and debt issuance](#). In our view, this is a signal of growing reluctance among euro area banks to lend reserves.

### ... with signs of funding pressures emerging

Repo rates cheapened over the past year with GC rates firmly above €str (Exhibit 6). This reflects increased bank demand for reserves and increased collateral supply. We expect Germany GC vs €str to trade between +5bp and +10bp, and for Italy GC to widen vs Germany GC. Even banks in cash rich countries are likely to need to pay up for funding if banks in cash poor countries compete harder for reserves. We stay in [ERU4](#) [€str wideners](#) to position for increased funding costs in the unsecured wholesale market (current: 11bp, target: 20bp, stop: 5bp). Risks are less reserve demand by banks than we expect, slower QT than we expect, and new lending operations introduced by the ECB that are widely used by banks.

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For a list of our open rates trades and those closed over the past 12 months, see the latest [Global Rates Weekly \(2 February 2024\)](#).

ECB: European Central Bank

€str: euro short-term rate

GC: general collateral

HQLA: high quality liquid assets

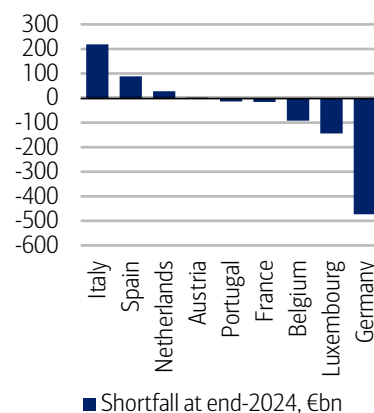
LCR: liquidity coverage ratio

TLTRO: targeted longer-term refinancing operations

QT: quantitative tightening

#### Exhibit 1: Reserve shortfall by end-2024

Italy and Spain may still need more reserves

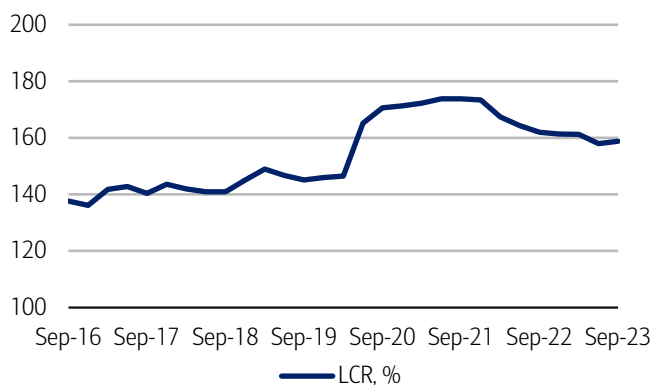


Source: BofA Global Research, ECB

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**Exhibit 2: LCR of Euro area banks**

LCR has been quite stable over the past year

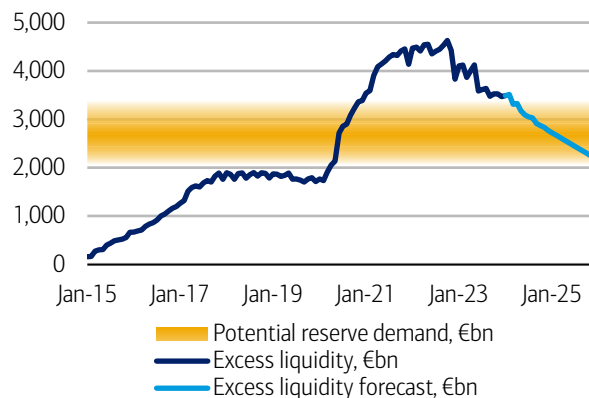


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**Exhibit 3: Excess liquidity supply and reserve demand**

Demand may outstrip supply in 2024

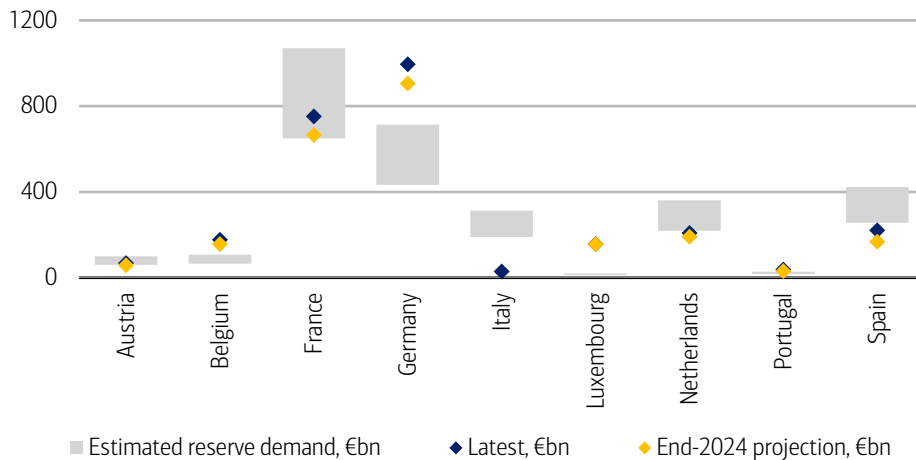


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**Exhibit 4: LCR demand by country and supply**

Banks in Germany have most scope to lend on a cross border basis

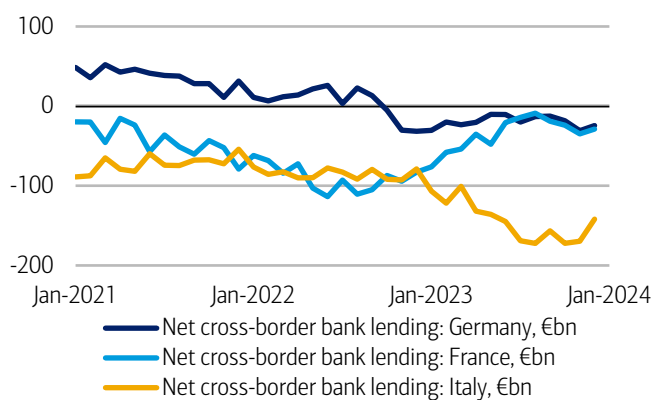


Source: BofA Global Research, ECB

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**Exhibit 5: Net cross-border bank lending**

Net lending by banks in France stalled while Germany remained stable

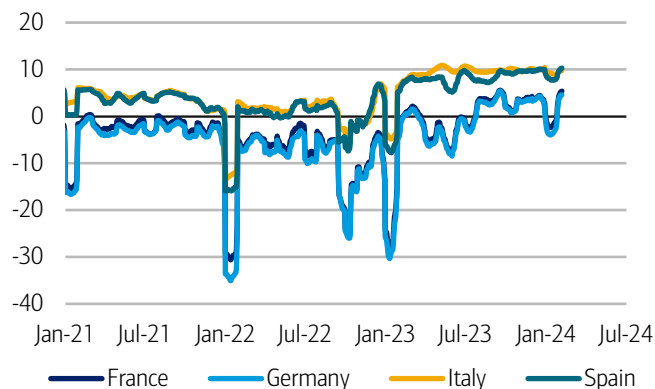


Source: BofA Global Research, ECB

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**Exhibit 6: GC rates vs €Str**

Repo cheapened and now firmly above €Str



Source: BofA Global Research, Bloomberg, CME Group

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