GERMAN COLLATERAL SCARCITY AND ITS IMPACTS

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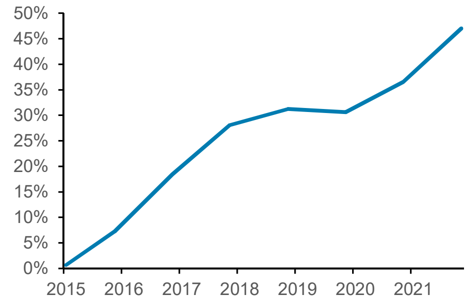
BNP PARIBAS

The bank for a changing world

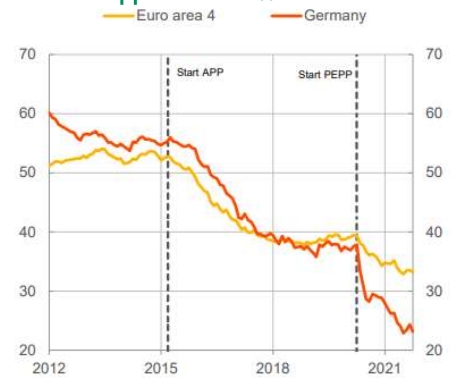
The bund Free Floating issue

Eurosystem holds 47% of outstanding public sector German collateral*



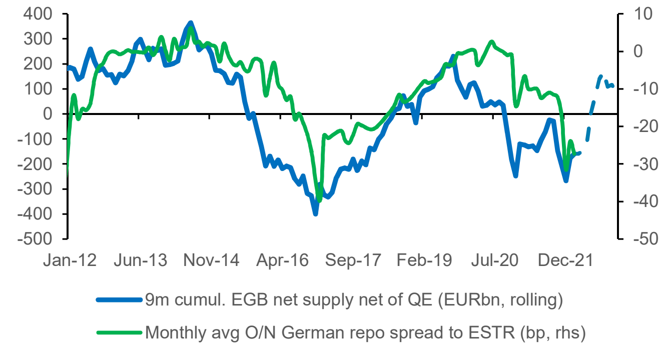
Sources: ECB, BNP Paribas

Free float approaches 20% with PEPP



Sources: ECB (The DE free float measures is defined as holdings by investors other than the foreign official sector, insurance companies, pension funds and the Eurosystem.

Scarcity of supply behind the collateral squeeze as ECB lending facility has not increased



*Sources: ECB, BNP Paribas (*sovereign, regions, eligible agencies)*

ECB holdings end-January 2022 vs end-2022

	End-Jan 2022			Dec-22		
	APP	PEPP	APP+PEPP	APP	PEPP	APP+PEPP
Germany	30%	16%	47%	30%	17%	47%
France	23%	12%	35%	23%	12%	35%
Italy	21%	12%	33%	21%	12%	34%
Spain	27%	14%	41%	27%	14%	41%
Netherlands	29%	17%	46%	29%	17%	46%
Belgium	21%	12%	33%	21%	12%	33%
Austria	29%	15%	43%	29%	15%	44%
Portugal	30%	18%	48%	30%	19%	49%
Finland	33%	19%	52%	33%	20%	53%
Ireland	28%	16%	44%	28%	18%	45%
Greece		41%	41%		41%	41%
Total	26%	14%	40%	26%	14%	40%
Supras	37%	17%	53%	32%	15%	47%

Sources: ECB, BNP Paribas

Forecasted negative net supply at beginning of year

2022 monthly net EGB issuance net of QE breakdown (EURbn)

	Act.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	
2022 Net supply minus QE (excl. reinvestments)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2022
Austria	6	-1	2	0	3	2	3	2	0	2	-10	-1	7
Belgium	3	7	-11	-1	5	4	3	1	-10	1	4	0	5
Finland	3	2	0	-5	2	1	0	3	-4	1	1	0	3
France	19	-5	19	-27	-9	20	11	16	19	-18	18	4	69
Germany	-12	8	-3	-8	21	-4	-7	17	-15	1	19	-9	9
Greece	2	-1	2	0	2	2	0	-3	2	-1	0	0	4
Ireland	3	-1	-7	2	1	0	1	0	1	-4	1	0	-4
Italy	21	21	3	3	-7	17	8	-7	-34	22	-19	-10	20
Netherlands	-11	4	1	5	2	2	-14	1	7	3	3	0	2
Portugal	2	2	0	3	1	1	1	-1	0	-9	1	-1	-1
Spain	15	-15	6	13	-12	16	10	5	14	-9	10	3	56
Total in 2022	51	20	13	-13	8	62	15	33	-19	-13	27	-15	170
Total in 2021	70	24	11	-43	4	14	-28	-19	-62	-49	-35	-49	-162

Sources: ECB, BNP Paribas

German Finance Agency/ECB/BUBA – Catalysts for Involvement

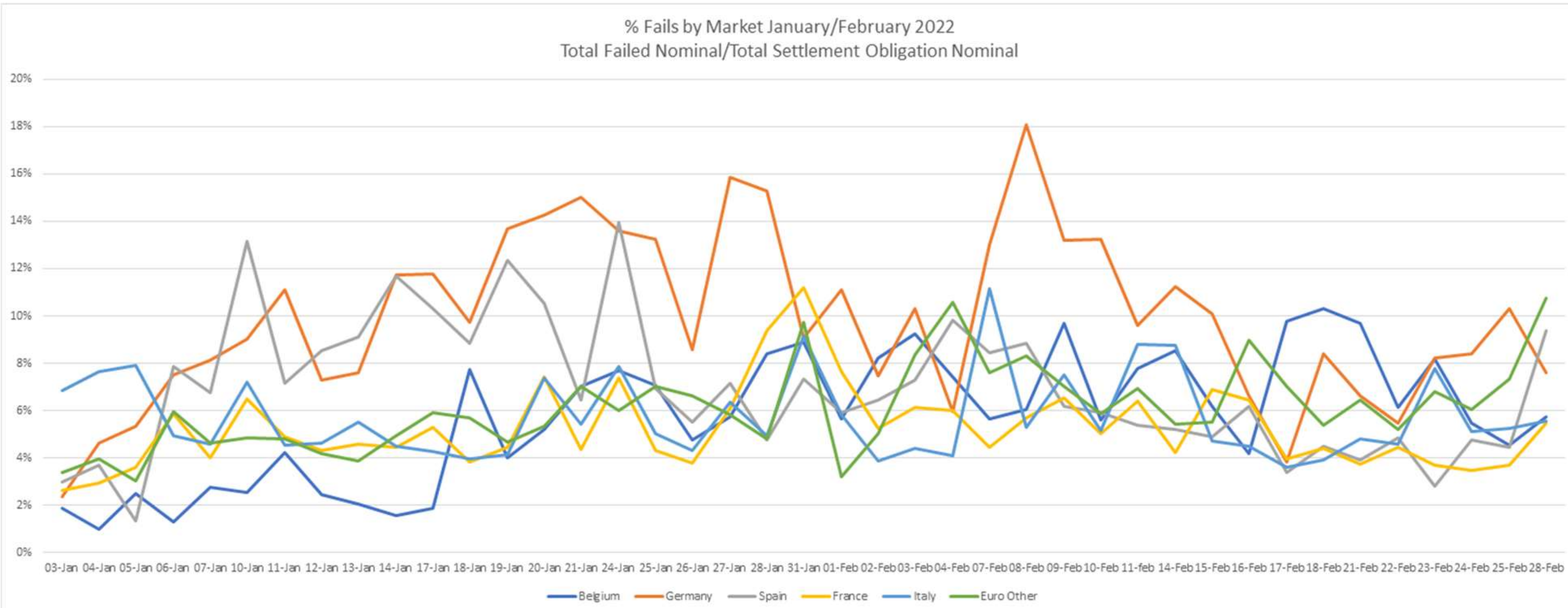
- General scarcity of collateral
  - Due to specific pandemic-related conditions like PEPP and TLTRO

- Crowded trades
  - Excess leverage in the system
  - Short basis (short bonds vs futures) – QE intermediation
  - Rich asset swap
  - Fast money short positioning into end of PEPP and APP

- Potential cross currency reserve management by foreign central banks, more predominantly in Germany

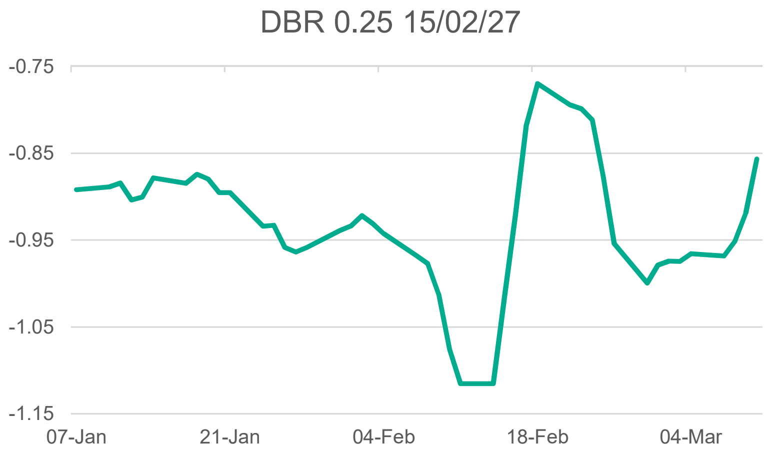
LCH CCP Fails

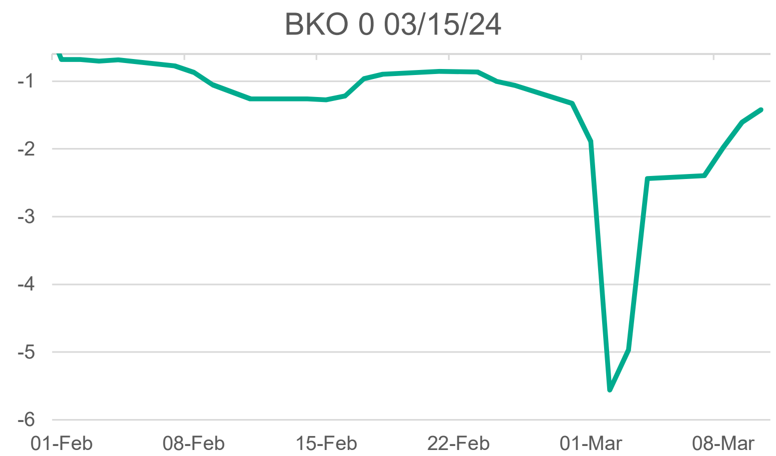
- BNP has canvassed heavily for mandatory membership of auto-borrow programme, shaping and auto-partialling
- BNP also recommended a pass-through mechanism that is more reflective of actual costs of fails than CSDR charges

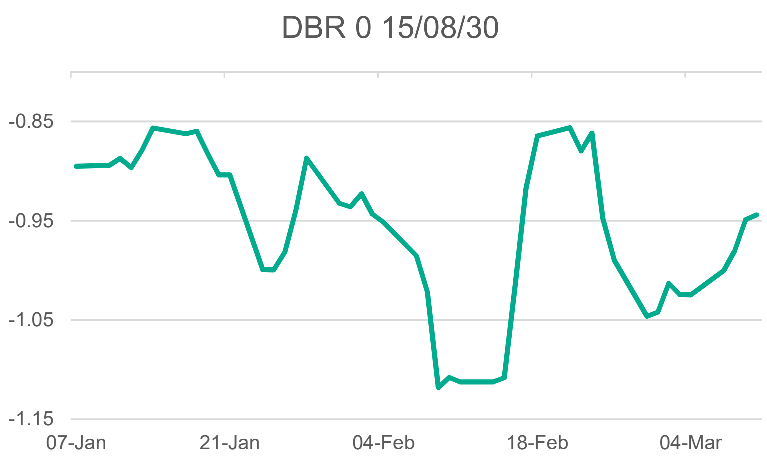


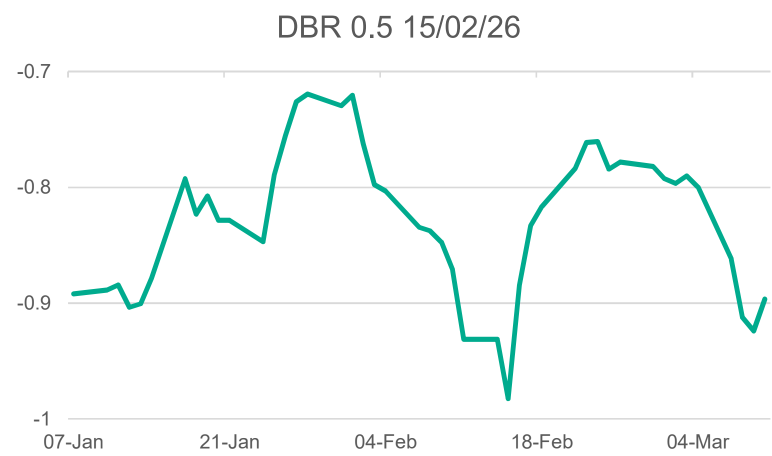
Source: LCH SA

German Specials









Source: BNPP

German Finance Agency – Mitigations

- German finance agency announced that it would step in to ease any potential collateral squeeze and support smooth functioning of repo markets
- Buba has discussed increasing counterparty limits to alleviate the degree of specialness
- Reduction of leverage in huge flight to quality in aftermath of Ukraine-Russia crisis
- ECB has actioned the following
  - ECB increasing amount borrowed vs cash from €75bn to €150bn
  - ECB (via Deutsche security lending) also increasing counterparty limits

- Specific mitigation for Mar 24 Schatz announced 3 Feb
  - German finance agency to increase holdings of Mar 24 Schatz by €2.5 billion to €8.5 billion, with volume to be used **exclusively** for short-term repo and securities lending transactions

Central Securities Depositories Regulation (CSDR)

- CSDR was implemented on 1st February, mandating all market participants as liable to pay daily penalties and/or charges against each failed transaction
- Instruments include all transferable securities and money market instruments, across CSDs in all EEA countries
- Mandatory buy-ins were discussed during the decision process to be standard practice. We were not supportive of it, and finally a fail penalty was decided upon.
- Government bonds now incur a penalty rate of 0.10bps per failed settlement
- However the actual costs of failed settlements largely exceed the penalties, and the CSDR penalties are not significant to deter poor settlement discipline in the market

Impact of German bonds scarcity on derivatives and other Euro Government bonds hedging costs

- **German bond futures are, in normal times, the first hedging tool for first-order delta risk of market makers in EUR swaps and bonds (govies, credit…)**
  - Because they are supposed to be extremely liquid
  - Because their relative value versus other rates products is understandable

- **The German asset swap value becomes extremely difficult to read as it embeds:**
  - Collateral scarcity price
  - German sovereign credit price

- **Recent volatility creates the need for an alternative to German debt when hedging this risk**
  - But other markets available may not have either the necessary liquidity
  - Hence there is a need for market makers to reduce this hedging risk
    - by avoiding proxy hedges as much as possible

- **This leads to wider bid-offer spreads and reduced liquidity offered by market makers**

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