Demand for reserves in the money market amid a shrinking Eurosystem balance sheet

Money Market Contact Group

26 March 2026

Belfius Bank

Transition to a new liquidity regime: from abundance to a demand-driven framework

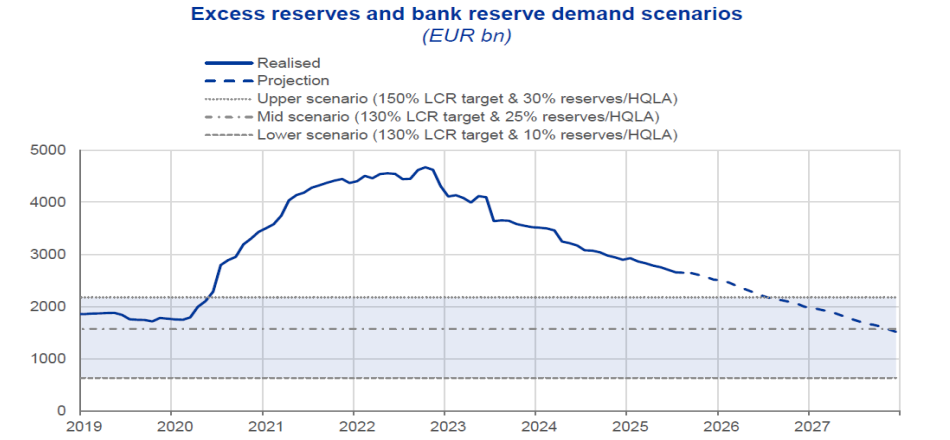
Towards a new liquidity regime

- The euro area remains in an ample-reserves regime but the operating environment has changed.
- The system is transitioning:
  - from a regime where aggregate excess liquidity dominated price formation
  - to one where banks' demand for reserves increasingly drives money-market pricing and behavior
- As reserves decline:
  - Banks' effective demand for reserves becomes more binding
  - Liquidity becomes more price-sensitive
  - Money market spreads widen before volumes adjust
- This is a regime transition, not a cliff-edge event. We are not moving abruptly from abundance to scarcity.

This transition is non-linear

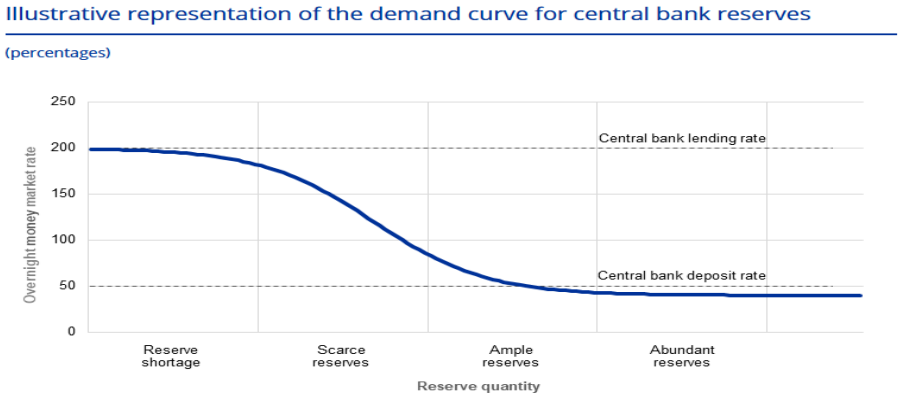
- ECB analysis highlights a non-linear relationship between excess liquidity and money-market rate sensitivity.
- More recently, GC repo rates have become mildly more sensitive to liquidity conditions than unsecured rates.
- As liquidity decline, stress shows first in prices (spreads/dispersion: €STR-DFR, Euribor–€STR, GC repo–DFR/€STR), not in headline excess liquidity.

ECB reserve demand scenarios based on alternative assumptions regarding LCR targets and reserves shares in HQLA



Sources: ECB (Supervisory statistics and MOPDB), ECB calculations.
Notes: The simulations take the current levels of the LCR and the share of EUR reserves in HQLA for significant banks and show the hypothetical reserve demand that would correspond to specified aggregate reserve shares and LCR target levels. It is assumed that less significant institutions target the same level as significant banks and that the other banks holding EUR reserves with the Eurosystem experience a proportional decline in reserves as the banks covered by LCR reporting. Scenario lines should not be interpreted as point estimates. The projections are based on quarterly Eurosystem internal balance sheet projections and assume take-up in standard refinancing operations is in line with the median SMA respondent.

ECB analysis shows that as reserves decline, rate sensitivity rises non-linearly



Source: ECB.
Note: For reasons related to the interplay between banks and other financial institutions, money market rates can settle moderately lower than the central bank deposit rate, as has been the case in the euro area over recent years.

Early signs of market normalisation

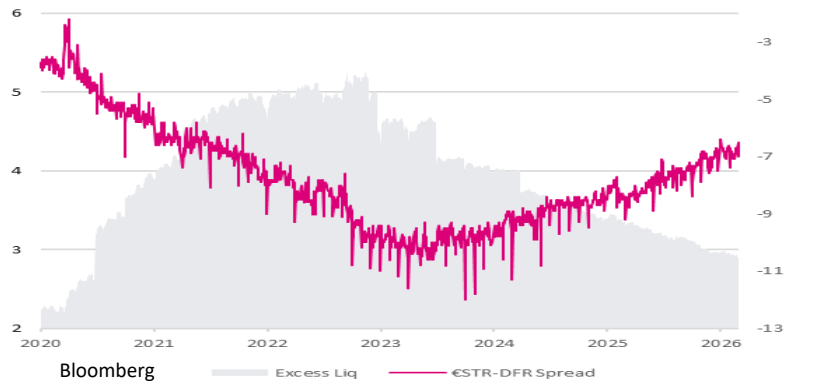
As excess liquidity declines, spreads widen before volumes become constraining

- €STR remains anchored close to the DFR but a gradual €STR–DFR tightening signals increasing competition for reserves.
- 3M Euribor–€STR spreads have widened, reflecting higher term funding premia and rising sensitivity to liquidity expectations.
- Secured rates increasingly reflect balance-sheet constraints and collateral dynamics, making repo an increasingly important marginal pricing market in the transition phase.
- Adjustment remains orderly: no broad funding stress, reserve redistribution still functions via repo and cross-border flows.

QT affects both reserves and collateral conditions

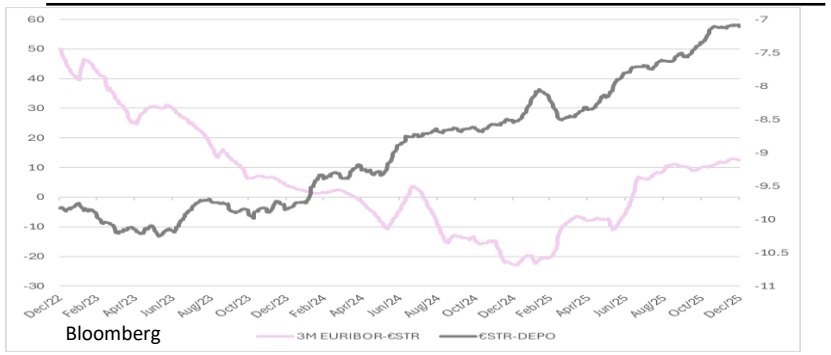
- Declining reserves increase the marginal value of liquidity while rising collateral supply increases reliance on repo financing.

€STR-DFR spread, bp (rhs) - Excess liquidity, trn (lhs)



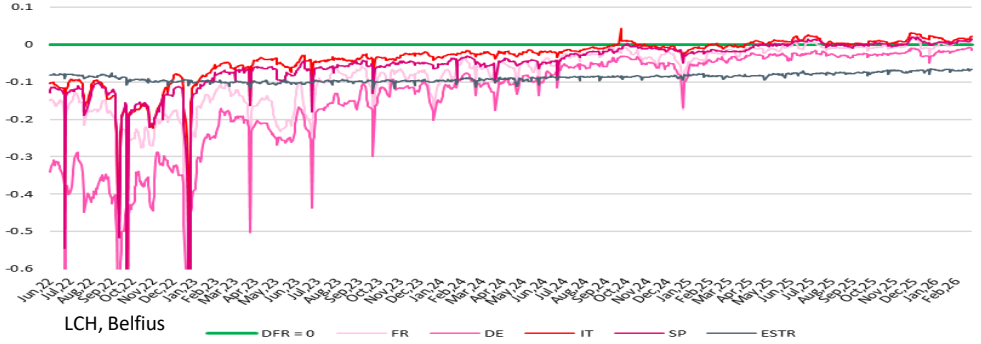
Bloomberg

1M rolling average 3M EURIBOR-€STR, bp (lhs), €STR-DFR spread, bp (rhs)



Bloomberg

GC repo-DFR spreads (bp)



LCH, Belfius

Distribution of reserves across the euro area banking system

Why reserve distribution, not aggregate liquidity, matters

➢ **Concentration of Reserves**
Reserves are concentrated in systemic banks with significant operational needs and high payment activity, causing uneven liquidity distribution.

➢ **Shift to Market-Based Redistribution**
Liquidity redistribution now relies more on repo markets, moving away from central bank automatic reallocations.

➢ **Price and Collateral Sensitivity**
Redistribution is increasingly price-driven and collateral-dependent, making liquidity sensitive to collateral availability and risk appetite.

➢ **Geographical Distribution Risks**
Uneven reserve distribution can lead to local liquidity tensions even when aggregate liquidity remains ample.

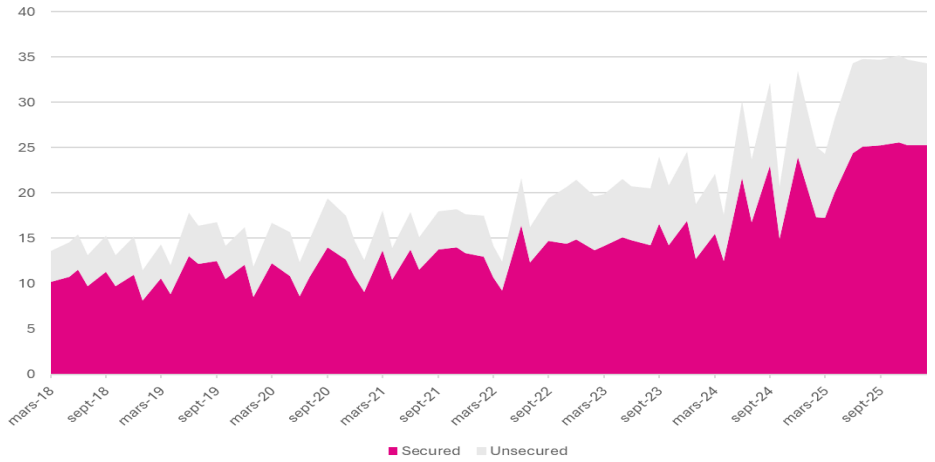
➢ **Structural Demand and Reserve Stickiness**
Structural reserve demand is driven by regulation, payments and precautionary buffers, limiting interbank reserve availability and increasing reliance on secured funding.

➔ **Reserve demand is sticky and heterogeneous.**

➔ **Repo markets become an increasingly important channel for reserve redistribution.**

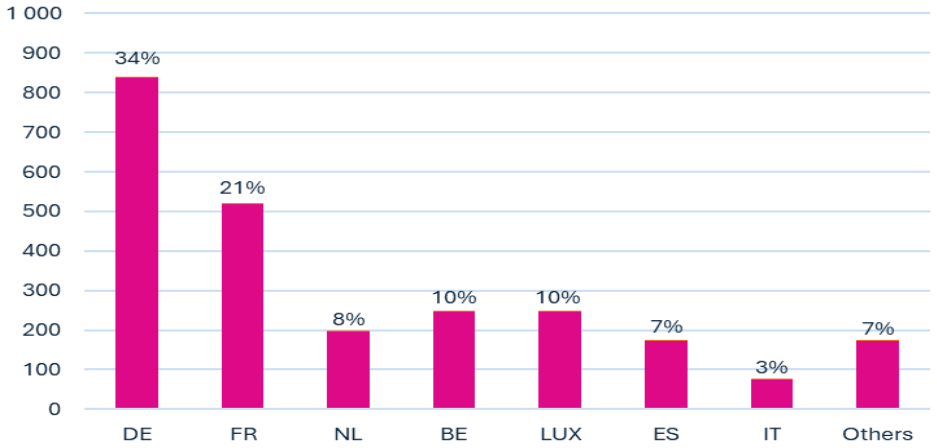
Growing importance of the repo market

MMSR secured and unsecured overnight borrowing by euro-area banks (EUR, bn)



Germany and France hold roughly 55% of reserves

Excess liquidity redistribution by country (EUR, bn)



ECB data (Dec 2025)

Liquidity redistribution: greater reliance on repo markets

The evolution: From automatic to market-based redistribution

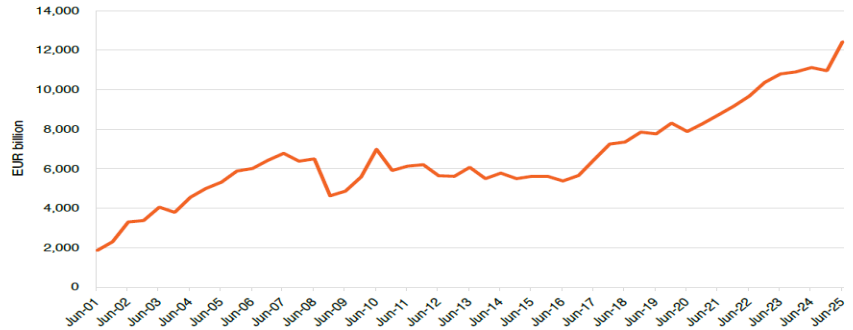
- As excess liquidity declines, redistribution relies more on market mechanisms, where repo supports cash redistribution, collateral mobility and transformation as well as price discovery for liquidity.
- Effective liquidity depends on regulatory HQLA usage and dealer balance-sheet intermediation capacity, not only on gross collateral supply.
- Repo-€STR spreads provide an early signal of changing liquidity conditions as intermediation costs and sensitivity rise.

Orderly transition so far, but sensitivity is rising

- So far, adjustment has remained orderly:
  - repo rates anchored near the DFR
  - no broad volume dislocation
  - no stress at reporting dates
- However, reliance on repo implies:
  - higher sensitivity to balance-sheet constraints
  - stronger effects around reporting dates
  - faster transmission of liquidity tensions through secured markets
  - potential further repo spread adjustment needed to incentivize use of MRO

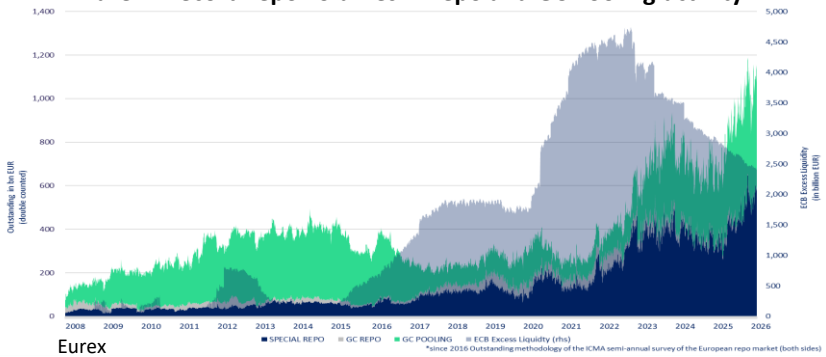
EU repo market size ~ €12,4trn mid-2025

Figure 2.1 – Outstanding value of total business by the survey sample



ICMA

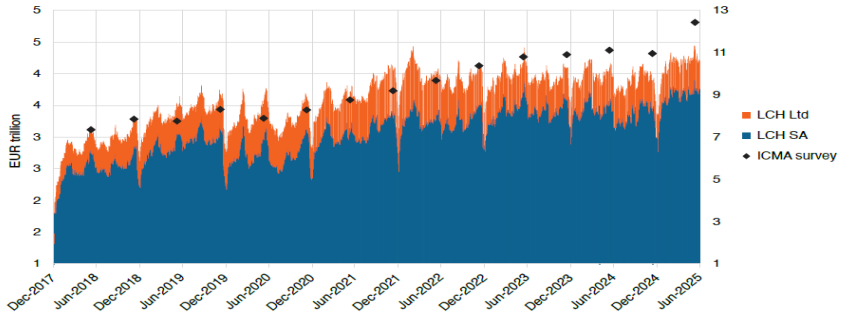
Eurex : Record repo volumes in repo and GC Pooling activity



Eurex

LCH: Sustained and consistent growth over time

Figure 2.13 – Daily outstanding nominal value of cleared repos on LCH RepoClear 2018-2025



Source: LCH. Note: double-counted

Repo market participants and liquidity providers

Who provides liquidity in the repo market today ?

- Core intermediaries:

  Dealers/primary dealers
  - Transform cash ↔ collateral and redistribute reserves
  - Provide maturity, collateral and counterparty transformation
  - Constrained by leverage ratio, G-SIB buffers, balance-sheet costs

- Cash providers

  Money Market Funds
  - Large and rate-sensitive
  - Pro-cyclical (rates, quarter-ends)

  DMOs & official institutions
  - Invest temporary government cash balances (reverse repo, deposits)
  - Operate securities lending facilities, influencing sovereign collateral supply

  Asset managers / pension funds
  - Stable but operationally constrained participants

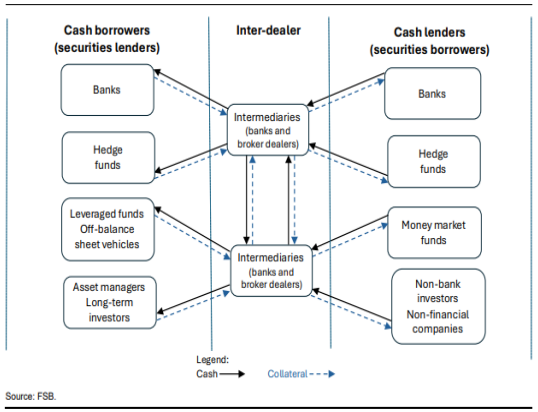
- Collateral takers / transformers

  Banks & hedge funds
  - Use repo to fund inventories, hedging and leverage
  - Drive specials and collateral demand volatility

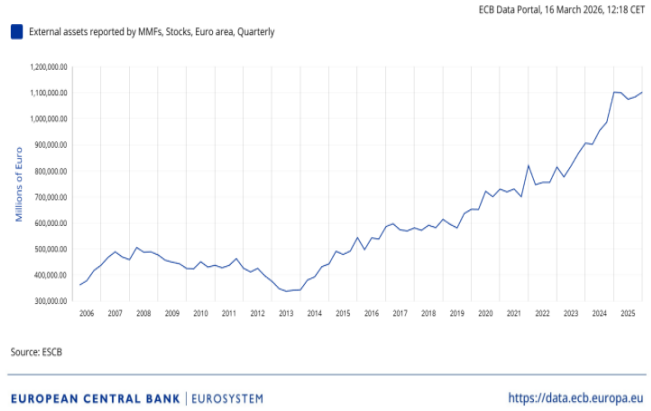
- Market infrastructure

  CCPs (Eurex, LCH)
  - Support netting/efficiency
  - Improve transparency and access, but cannot replace dealer balance sheets

FSB diagram of counterparties in repo markets



External assets reported by MMFs



The specific role of DMOs : smooth repo markets but do not anchor them

Cash-management channel

- Temporary placement of government cash balances:
  - Can soften GC rates and ease short-tenor funding
  - Particularly relevant around issuance peaks and quarter-ends

Collateral channel - DMOs influence collateral supply via

- Sovereign issuance and buy-back determine:
  - Free float of benchmark bonds
  - Specialness dynamics
- Securities lending facilities:
  - Mitigate collateral scarcity
  - Smooth settlement and specialness stress

Key limitation

- Cash flows are episodic and calendar-driven
- DMOs do not provide standing liquidity

➔ DMOs and official institutions can be an important but episodic source of cash in the repo markets. Changes in their behavior can have a significant impact on repo rates and liquidity conditions.

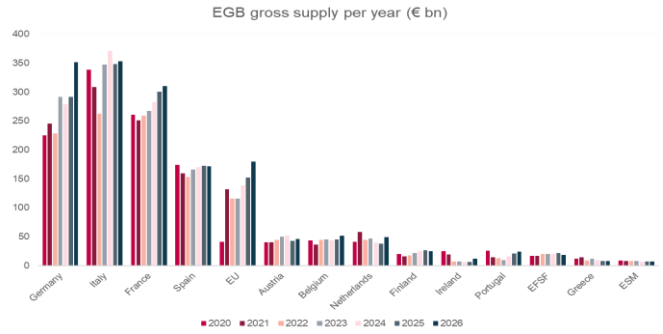
➔ As excess liquidity declines, repo markets may become more sensitive to DMO cash swings, even if aggregate liquidity remains ample.

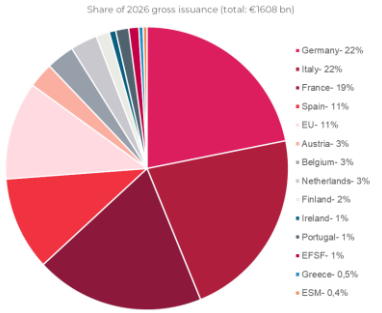
Collateral supply dynamics and emerging market vulnerabilities

Repo markets are backed by a sustained high net issuance, increasing free-float collateral

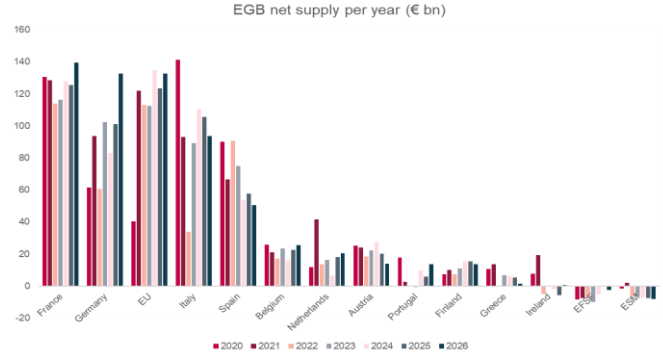
- Gross issuance ~€1.6 trn, mainly concentrated in Germany, Italy and France
- Demand from insurers, pensions and repatriating European investors remains strong but financing still requires repo intermediation
- More collateral to fund does not imply more balance-sheet capacity to intermediate it

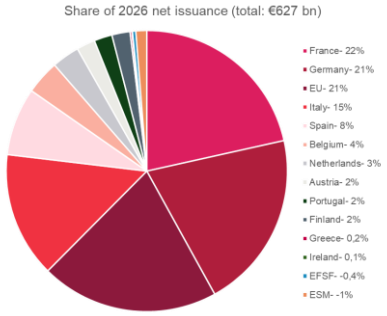
GROSS SUPPLY





NET SUPPLY





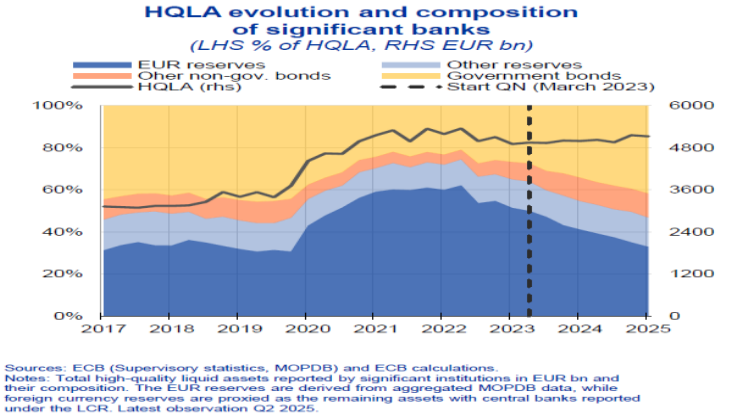
Repo markets are supported by higher net issuance but vulnerabilities may emerge

- **Intermediation capacity as a binding constraint**
  - Repo market functioning depends on dealer balance-sheet capacity, which may become more binding as volumes rise, even when collateral supply is ample
- **Pro-cyclical dynamics**
  - In stress, risk appetite may decline, margin requirements can rise and intermediation capacity can contract, amplifying rate and spread movements
- **Non-bank and official flows**
  - Greater reliance on non-bank cash providers and DMO cash management flows, which are rate-sensitive and episodic, may raise short-term volatility
- **Collateral supply versus effective liquidity**
  - Higher free float (QT + fiscal deficits) does not automatically translate into higher effective liquidity when regulatory demand for HQLA and balance-sheet constraints reduce collateral velocity

➔ Market pressures tend to appear first in price dispersion, specialness and reporting-date volatility

Evolution of non-HQLA collateral usage and implications for HQLA redistribution

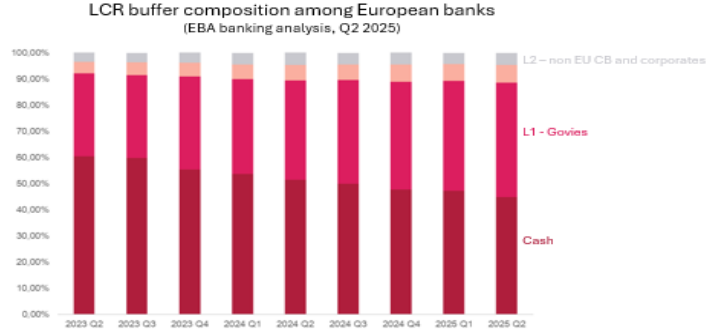
Banks' HQLA composition has shifted: lower cash share, higher securities share, alongside sustained sovereign issuance.



Sources: ECB (Supervisory statistics, MOPDB) and ECB calculations.
Notes: Total high-quality liquid assets reported by significant institutions in EUR bn and their composition. The EUR reserves are derived from aggregated MOPDB data, while foreign currency reserves are proxied as the remaining assets with central banks reported under the LCR. Latest observation Q2 2025.

➢ **Increasing use of non-HQLA collateral**

- As reserves decline, banks increasingly preserve HQLA (reserves and top quality bonds) for regulatory and operational needs.
- Regulatory liquidity is increasingly generated via repo using non-HQLA collateral.
- Examples include retained covered bonds, lower-quality credit and structured products, as well as greater use of term repo.
- Pricing becomes more collateral-differentiated: higher haircuts, greater specialness and wider spreads.



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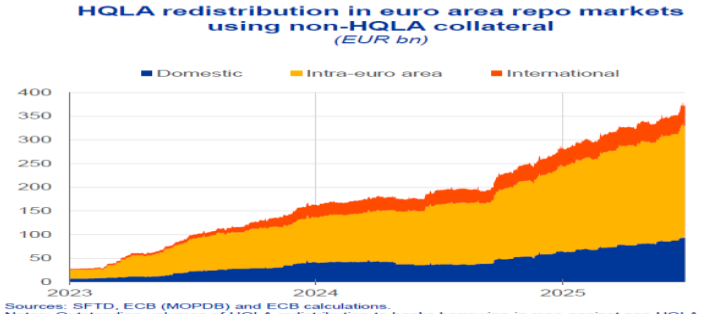
➢ **Impact on HQLA redistribution**

- HQLA can become less mobile and more concentrated in buffers
- Redistribution shifts toward secured markets and depends more on collateral quality and dealer balance-sheet capacity
- Greater dispersion emerges across counterparties, collateral types and jurisdictions



Sources: SFTD, ECB (MOPDB) and ECB calculations.
Notes: Outstanding volumes of HQLA redistribution to banks borrowing in repo against non-HQLA collateral, residual maturities above 30 days and accounting for the LCR haircuts of the underlying collateral and counterparty. Domestic cover within EA country repos, intra-euro area borrowing repos of a bank from a counterparty that are both located in the euro area and International is repo borrowing between EA banks and counterparties located outside the euro area. Open-term repo or evergreen transactions are excluded.

Key takeaways

- Repo markets increasingly act as the main redistribution channel, with secured rates increasingly driving price discovery as reserves decline.
  Higher sovereign issuance and QT raise collateral supply, but effective liquidity depends on dealer balance-sheet capacity and collateral usability, not simply on aggregate collateral availability.

- Dealer banks remain central intermediaries, transforming cash and collateral and redistributing reserves across the system but their activity is increasingly constrained by regulatory balance-sheet costs.
  Non-banks and DMOs/official institutions influence repo market conditions but their flows are episodic and cannot anchor market liquidity structurally.

- Persistently high demand for HQLA can lead banks to preserve top quality collateral in liquidity buffers and use more non-HQLA collateral in repo, increasing collateral differentiation and dispersion.

Disclaimer