ICMA European Repo Market Study

‘Perspectives from the eye of the storm’

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Perspectives from the eye of the storm

The current state and future evolution of the European repo market
The study

- **Objective:** to paint a detailed picture of how the European Repo Market is evolving in response to various regulatory initiatives and monetary policy

- Largely qualitative, based on multiple semi-structured interviews with market practitioners

- Participants included: bank repo desks, buy-side participants (levered and real money), inter-dealer brokers, trading platforms, triparty agents, clearing houses, agency lenders

- June-October 2015: 45 interviews, 47 entities, over 60 individuals
Perspectives

- The game changer: the impacts of Basel III and CRD IV/R
- Changing business models
- Evolving bank-client ‘partnerships’
- Adaptation and innovation
- Monetary policy
- The risks arising from future regulation
- The future of the European repo market

“People think that the rules of the game have changed. The rules haven’t changed; it’s the entire game that has changed.”

- Repo Trader
The game changer: the impacts of Basel III and CRD IV/R

“The bottom line is that Basel III has made repo, as a traded product, far less profitable.”
- Repo Trader

Leverage Ratio

- Leverage ratio (and SLR) is making repo far more expensive as an on-balance sheet product.

- Netting becoming key: driving different pricing (and liquidity).

- Also driving innovation and initiatives for balance sheet efficiency (gross: net).

- But varies across jurisdictions (although trend for over-compliance).

- Not being applied uniformly across jurisdictions and banks.
The game changer: the impacts of Basel III and CRD IV/R

“Nobody wants short-term funding anymore. You can’t give it away.”

- Fund Manager

Liquidity Coverage Ratio

- Key focus for many European banks.
- Driving longer-dated average maturities.
- More activity in ‘evergreens’ or ‘extendables’
- Making shorter-dated repos less attractive (issue for cash lenders).
- Driving the collateral-upgrade trade.
The game changer: the impacts of Basel III and CRD IV/R

“Once NSFR comes in, then it’s game over. We can all go home.”
- Repo Trader

Net Stable Funding Ratio

- Will penalize short-term repo further, particularly with financial institutions.
- Could have implications for short-covering.
- Will make banks more reliant on unstable and short-term corporate funding.
- Uncertainty of how it will interplay with other Basel tenets.
So why is the repo market not contracting?

Source: The ICMA European Repo Market Survey, Number 29, September 2015
So why is the repo market not contracting?

- More emphasis on netting opportunities (increasing gross:net ratios)
- Timing of reporting of Basel ratios (daily average vs monthly average)
- Not all banks yet applying LR
- Way in which banks absorb capital costs of Basel (bank level vs trading desk level)
- Banks using repo as a loss-leader for more profitable businesses and client revenue streams
Changing business models

“The desks that react to the new environment the quickest, and take the pain up front, will be the ones that survive.”

- Repo Trader

- De-risking and de-leveraging
- From profit-centre to cost-centre
- Staffing
- A centralized liquidity and collateral management hub
- Developing the franchise
Evolving bank-client ‘partnerships’

“These days, trading is driven a lot less by price and a lot more by matching axes.”

- Fund Manager

- End of reliance on matched-book model for pricing and liquidity
- Pricing and liquidity being driven more by banks’ funding and liquidity needs
- Greater funding cooperation and client flexibility required
- Concerns about sustainability of current levels of liquidity and pricing
- Funds utilizing leverage most concerned
- Funds where repo/securities lending is an ancillary business do not need to lend securities if it becomes too expensive, onerous.
Adaptation and innovation

“Compared to other markets, evolution in the repo market has been glacial”.

- Infrastructure Provider

- Balance sheet optimization
  - Matching trades
  - Collateral-vs-collateral
  - Standardized ‘break-dates’
  - TRORS

- Central-clearing
  - ‘Pull-push’ of CCPs
  - CCP interoperability
  - Client clearing

- Triparty
  - Becoming primarily for low-grade funding
  - Standardization (LCR/HQLA baskets) vs bespoke (issue with UCITS)
  - Contractual framework alternatives
Adaptation and innovation

“There is a need to innovate and to open up the repo community; it can’t just be for the banks.”

- Repo Broker

- Electronification and (dis)intermediation
  - Standardization vs negotiation
  - Multiple considerations (counterparty, dates, collateral, haircuts)
  - Different trade-types
  - ‘Dealer-to-client’ and ‘all-to-all’ protocols
  - Hybrid models
  - Bank automation processes (negotiation-execution-settlement)

- Disincentives to innovation
Monetary policy

“It’s a difficult conversation trying to explain to your client that they are going to pay you to borrow their money.”

- Repo Trader

- Cash is trash
  - Excess reserves and negative rates

- QE vs HQLA

- Papering over the tracks
Risks arising from future regulation

“I keep thinking that as a market we’ve failed. With every bit of new regulation it becomes more evident that we’ve done a lousy job of explaining to regulators what a repo is and why the repo market exists.”

- Repo Trader

- Do policy makers and regulators understand repo?
- Net Stable Funding Ratio
- CSDR mandatory buy-ins
- SFTR
- BRRD resolution stays
- MiFID II/R
- Lack of certainty
The future of the European repo market

“At some point every bank is going to take a long, hard look at their fixed income businesses and ask themselves, ‘is it worth it?’”

- Repo Trader

- The market will be a lot smaller
- There will be more buy-side participants (and less sell-side intermediation)
- The market will become even more sophisticated
- Repo will become a lot more expensive
- Liquidity and collateral management functions will continue to merge

The two big unknowns:

- A pause in the regulation will restore optimism
- The withdrawal of central bank liquidity will reveal the cracks in the market
Conclusion

“The repo market isn’t going away. It might look very different, but it will still be around.”

- Infrastructure Provider

- Nothing is transforming and reshaping the structure and dynamics of the repo market more than Basel III.

- The Leverage Ratio (and SLR) is having the most profound impact on the repo market, where it is being applied.

- Repo market volumes and pricing in the European repo market do not appear to reflect the increased cost of capital required to trade repo.

- Most banks have restructured their repo business models or are in the process of doing so.

- Key trends include de-risking, deleveraging, transformation from a profit-centre to a cost-centre, reducing head-count, and the merging of repo desks with other funding functions to create centralized liquidity and collateral management hubs.
Conclusion

- **Bank-client relationships** are also being redefined and recalibrated, as repo becomes more difficult and complex to transact.

- As regulation challenges the traditional matched-book model, so stakeholders are trying to **adapt and innovate both** to meet those challenges and to exploit potential new opportunities.

- **ECB monetary policy** is having a potential dampening effect on repo activity. A further potential outcome is a reduction in the stock of high quality collateral.

- There is a high degree of concern and uncertainty related to the possible market impacts of tabled **future regulatory initiatives**, not least NSFR.

- There is broad concern as to the extent to which the repo market can continue to perform its various roles, efficiently and effectively.
About the European Repo and Collateral Council

- The ICMA European Repo and Collateral Council (ERCC) is the industry representative body that fashions consensus solutions to emerging, practical issues in a rapidly evolving marketplace, consolidating and codifying best market practice. The ERCC is also responsible for promoting the wider use of repo in Europe by providing information and education. ICMA is an active force in standardizing repo documentation, and sponsors the Global Master Repurchase Agreement (GMRA), which is the most predominantly used master agreement for repo transactions in cross border markets.

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About the author

- **Andy Hill** is a Senior Director in ICMA’s Market Practice and Regulatory Policy group. For seventeen years he has been a repo and money-market trader, and for ten years he was an Executive Director at Goldman Sachs. He has also worked as a consultant in the Aid and Development sector, primarily based in Cambodia, and previously served on the Board of the Cambodian NGO Education Partnership in Phnom Penh while under a Goldman Sachs Public Service Fellowship. He holds a BSc (Hons) in Business Studies from Cass Business School and an MSc in Poverty Reduction and Development Management from the University of Birmingham.

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