The euro repo market at March 2017 quarter-end

An ICMA ERCC briefing note
April 2017

Background

In March 2017, ICMA's European Repo and Collateral Council (ERCC) published a short report, ***Closed for Business***, which documents the unprecedented price dislocations experienced in the European repo market over the 2016 year-end. This followed increasing concerns raised by market participants related to thinning liquidity and price volatility over previous quarter-ends. The main concern is that the price action and sharp drop in liquidity observed over Basel reporting dates,[1] and in particular at the end of December, is an indication of a new normal for the European repo market, where demand-supply imbalances for high quality liquid assets (HQLA) are exacerbated as dealers restrict their repo intermediation services over quarter-end reporting statement dates.

The ERCC was therefore interested to follow repo market behaviour over the March 2017 quarter-end, which is also year-end for Japanese financial institutions.

March 2017 quarter-end

In the weeks leading up to March quarter-end (which, like the December year-end, spanned three calendar days), the market was understandably nervous, and the implied[2] core-HQLA general collateral funding rate priced in for those days was relatively conservative and wide (a spread of -2% / -3.5%). However, as the market reached the respective spot-next and tom-next dates for the quarter-end, it became clear that any funding pressures were relatively muted compared with December year-end, and both GC and specials levels, while still notably tighter than for normal dates, cheapened from their implied levels. German GC, for instance, settled around the -1.5% to -2% level (before returning to around -0.60%/-0.65% immediately after quarter-end).

Figure 1, below, shows the closing German Repo Fund Rate, along with daily volumes.[3] While the tightening in rates over the end of March is pronounced, it is not as severe as over the previous year-end. Meanwhile, Figure 2, shows the daily weighted average rates of five German 'specials' in the 'spot-next'[4] market. Again, levels noticeably tighten over the quarter-end, but not nearly to same degree as year-end.

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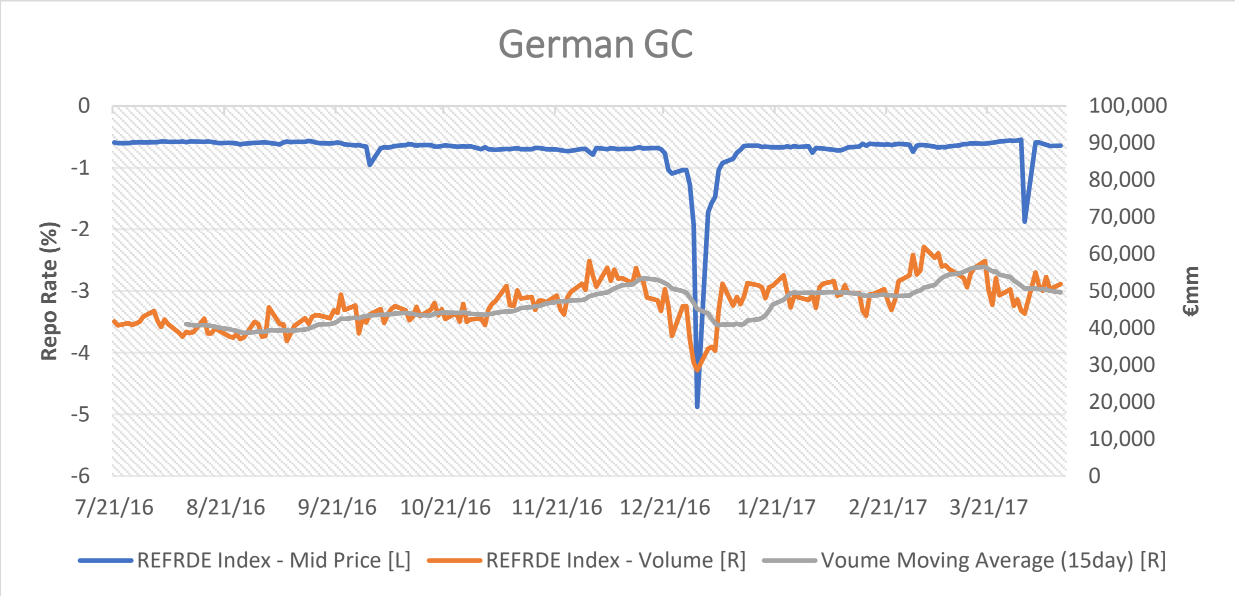
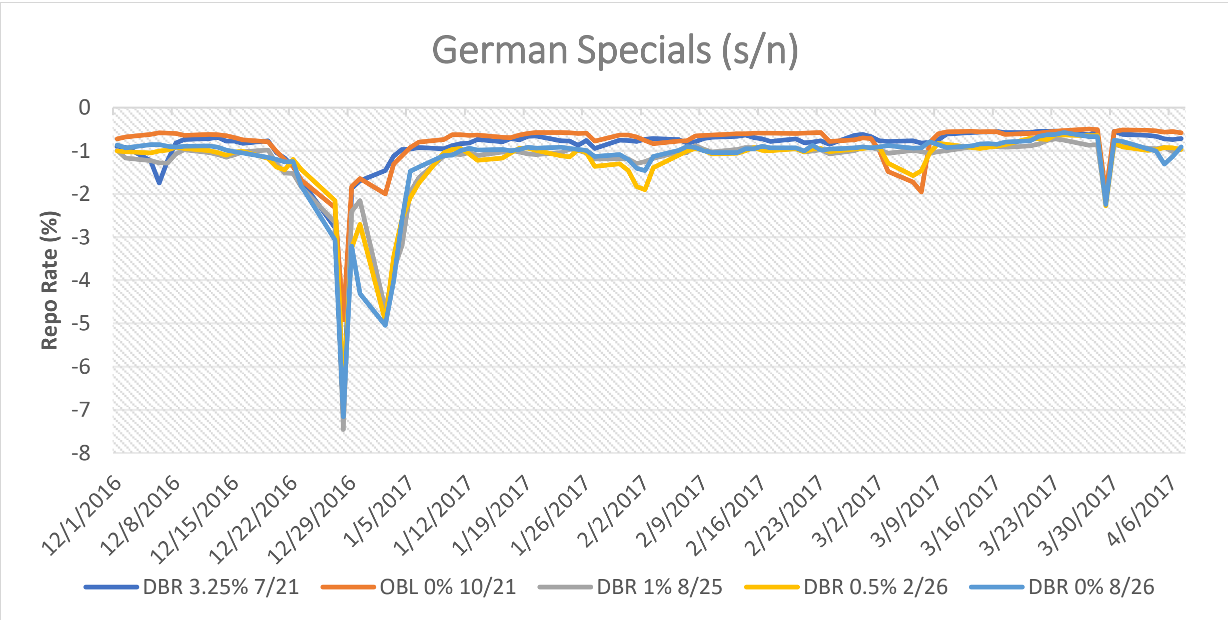
[1] In particular for Leverage Ratio and Liquidity Coverage Ratio (and soon, Nest Stable Funding Ratio).
[2] The implied rates over key dates, such as statement periods, futures delivery, etc., can be interpolated from the term General Collateral or specials curves.
[3] The Repo Funds Rate (RFR) is a daily euro repo index calculated from trades executed on the BrokerTec and MTS electronic platforms. All eligible repo trades are centrally cleared and RFR Euro is calculated and published by Nex Data Services Limited. RFR Euro is calculated with repo trades that use sovereign government bonds issued by any country in the Eurozone.
[4] Spot-next is a one-day repo with the first leg settling two days after trade date ('spot') and the second leg settling three days after trade day (i.e. the next day). Spot-next and tom-next are the most popular traded terms for euro repo markets, with spot-next tending to be more common for specials.

Figure1: German GC rates and volumes



Source: Bloomberg

Figure 2: German specials rates



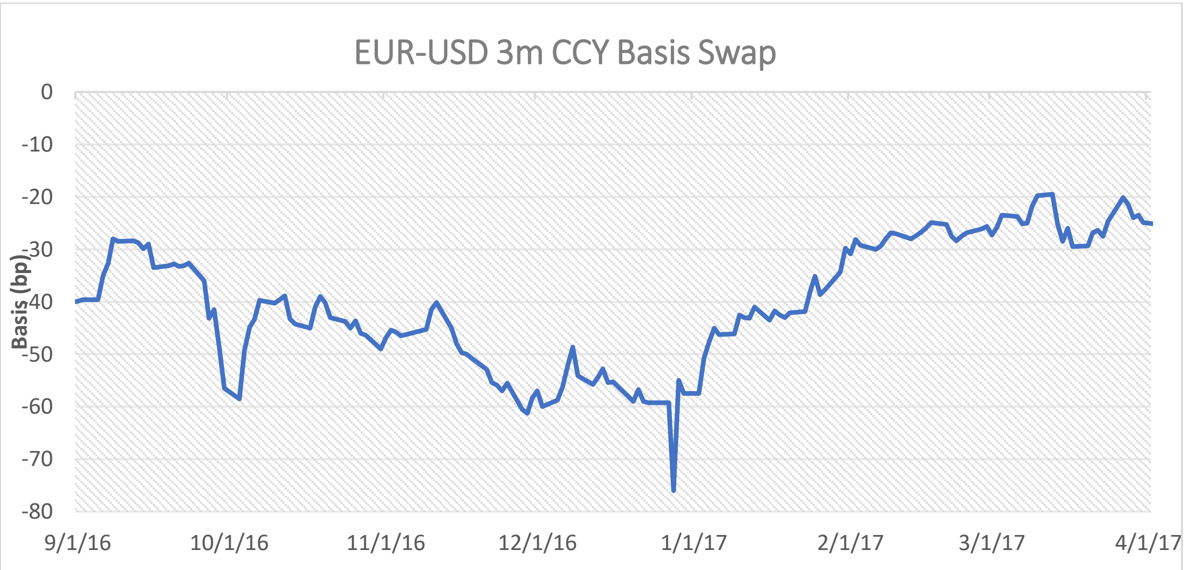
Source: Nex Data Services Limited (BrokerTec)

Why was March quarter-end different?

The ERCC study into the 2016 year-end dislocations identifies three key factors that cumulated to create the perfect storm: (i) market positioning; (ii) the effects of quantitative easing (compounded by an inadequate lending program); and (iii) regulatory impacts on bank intermediation.
Based on discussions with market participants, the following factors seem to have played a part in the relatively muted market dislocations observed over March quarter-end:

- It is reported that there was an increase in term trades (specials and GC) over the March quarter-end, as participants tried to lock-in their funding well in advance of quarter-end. However, it should be noted that UCITs money market funds are limited to 7-day investments, and some report that they still struggled to find liquidity as the quarter-end date approached.
- The short-interest in core bond markets (in particular Germany and France) was significantly less than at the end of December. Furthermore, where firms were running short positions, many also bought short term assets (such as bills) to ensure that they could achieve funding over quarter-end by providing their dealer banks with netting opportunities (counterbalancing both long and short funding positions).
- Important non-European lenders of core HQLA (such as large non-European asset managers) were active over quarter-end.
- Dealers and brokers report that it felt as if there was ‘more balance sheet being put to use’ compared to year-end.
- A number of stakeholders have noted that, at the margins, the modifications to some of the central bank lending programs since the start of the year had also eased some of the pressure.
- The EUR-USD currency basis swap had largely normalized since December, reflecting a reduction in the structural imbalance between banks’ EUR holdings and USD funding needs (see Figure 3). In early January, the FX-forwards had been pricing in the March quarter-end EUR-USD basis at -8.5%.

Figure 3: EUR-USD Cross-currency Basis Swap (3 months)



Source: Bloomberg

Conclusion

Many repo market users breathed a sigh of relief at March quarter-end, given the significant price and liquidity dislocations over year-end. However, it remains clear that anticipating HQLA demand-supply imbalances over reporting dates, as well as the capacity of repo dealers to intermediate, remains highly unpredictable, and the associated risks for market participants are largely asymmetrical.

ICMA's ERCC will continue to monitor European repo market liquidity and functioning closely, and share its observations and analysis with interested regulatory bodies and policy makers.

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