Buy-Side Interest in Cleared Repo Builds

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RepoClear

As the use of repo expands across the industry, real money managers and other buy-side segments are actively moving towards a cleared repo model. This is an important step for the market that will not only address growing concerns about access to funding but potentially increase the size of the liquidity pool at the same time.

Until recently, buy-side institutions have been limited in their access to the cleared repo market, relying instead on a complex matrix of bilateral relationships that require a high degree of operational effort. While this works satisfactorily enough, pressures on bank capital have restricted balance sheets and removed capacity from the market. This has disproportionately impacted smaller buy-side participants, which may have less extensive relationships with the major banks.

The emergence of peer-to-peer repo trading platforms supporting uncleared activity is a direct result of the restricted liquidity and capacity. To date, though, they have made slow progress, as many participants remain unable to trade with each other. For those that do execute on a peer-to-peer basis, the documentation and credit due diligence requirements can be difficult to support.

While peer-to-peer activity will always remain an option for the buy-side, recent developments in CCP solutions are gaining traction, leading to a price differential developing between cleared and uncleared customer activity. The factors behind this are to some extent regional.

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In the US, banks have more transparently priced their balance sheets in response to regulatory pressure and the accounting regime, driving money market funds in particular to clearing. A slower move to average balance sheet accounting in Europe has allowed some banks to continue to provide balance sheet most of the time. As more European banks adopt average balance sheet accounting, repo capacity is likely to be restricted.

While the differences in accounting principles between US GAAP and IFRS lead to different CCP models, the results for participants are the same, with banks typically able to provide more repo capacity and at lower costs in a CCP than as a counterpart themselves.

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This increased repo capacity is perhaps chief among the advantages of central clearing for buy-side firms. Additionally, access to the pooled liquidity that a clearing house provides enables significant operational efficiencies relative to the bilateral bank market or the peer-to-peer model. These efficiencies include day-to-day settlement netting, as well as access to a much larger pool of counterparties, without the need for more documentation.

Until recently, pressure on repo pricing had not been enough to encourage any change in behaviour among smaller buy-side firms, and the larger institutions were not experiencing any funding pinch due to their highly valued relationships with banks. As these economics shift, the move to a cleared repo model is accelerating.

In addition to the underlying advantages of a cleared repo model for the buy-side, the shift to this model has the potential to drive other network benefits. In particular, as buy-side firms hold the vast majority of securities inventory, they now have a better opportunity to lend them back. By doing so, they can inject greater liquidity into a sector that has been — and remains — systemically important for banks, regulators and other participants. That can't be a bad thing.

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