Cleared Repo Steps into the Limelight

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RepoClear

Since the 2008 financial crisis, securities financing has been directly impacted by regulatory developments, including the leverage ratio. While European repo volumes are at record levels, these developments are now starting to bite, increasing costs for banks and resulting in greater scrutiny of how capacity is awarded to their clients.

The reasons for this are straightforward. For banks, the incremental cost of a new financing trade can significantly exceed its profitability, so the value of the overall client relationship has become much more important in assessing the allocation of capital. For most repo trading desks, the allocation of bank capital constrains how much of the balance sheet is apportioned to individual clients. Even though a large client is often not impacted, it is difficult to increase this allocation if needed, and unless it is used, it can easily be reassigned elsewhere.

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CAPACITY IS IMPACTED

The incentive for banks to execute longer-term repo and shorter-term reverse repo and deal with more highly rated counterparties has increased. Banks are under greater pressure to fund from more stable sources, collateralise all loans and receive haircuts.

Against this backdrop, smaller institutions and those that trade less frequently may find it much more difficult to access repo capacity, and they could already be restricted in the business they can execute. Repo desks are now challenged to reduce or net trades over reporting dates. This is particularly relevant to banks that have yet to adopt average balance sheet accounting and are 'window dressing', which the Basel Committee indicated was unacceptable late in 2018.

UNINTENDED CONSEQUENCES

Creating consistent regulation is not easy. There are many participants undertaking similar, but notably different, business with different counterparties, for customers in and across multiple jurisdictions. Regulations are sometimes interpreted or enforced in different ways and at different times, meaning the playing field can be far from even. This can provide an opportunity for some to take a competitive advantage by entering a market in which they may not previously have traded. The reverse is also true, in that some participants may leave markets and look for other opportunities if they are disadvantaged.

Ultimately, markets will find a happy medium, and pricing will change to reflect this, but it can take time for regulatory effects to be realised and for equilibrium to be reached.

In Europe, an unintended consequence of regulatory developments has been a growth in non-cash-collateralised securities financing activity that is not reported on the balance sheet. In the US, impending regulatory changes are expected to result in a similar trend. New regulations, such as the Securities Financing Transactions Regulation (SFTR), will highlight some of this non-cash-collateralised activity, but it's not clear yet what the impact of this will be.

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THE ROLE OF CCPS IN CAPACITY CREATION

Despite these intended and unintended consequences, traditional cash-collateralised activity is growing, largely due to the netting potential clearing offers. Banks have embarked on a significant drive to reduce their risk and consequently their balance sheet utilisation by either deliberately offsetting bilateral trades or by multilateral netting within a CCP.

However, for end users, a challenge remains. While peer-to-peer trading is an option for the buy side to access the market, the reality is that it is difficult for 'peers' to trade with each other. They are sometimes not allowed to, but where they can, the legal and credit monitoring requirements can be onerous.

In the US, money market activity via CCP has grown rapidly, largely in response to reduced capacity and widening prices. The dynamics are different in Europe, mostly due to the accounting treatment of contingent guarantees. The result, however, is the same: capacity and pricing are being affected, and participants are required to change how they access secured markets.

The problem money market funds have faced exists for all directional end users, including net lenders and borrowers. These clients always impact a bank's balance sheet if they trade directly so, for them, the only balance-sheet-friendly solution appears to be to clear trades using a CCP or by cultivating relationships through peer-to-peer activity.

The CCP solution for repos has historically only been available for interbank activity with very little 'client clearing'. However, while buy side institutions have been slow to join the membership of CCPs, this is changing, and many now appreciate the capacity and risk reducing benefits a CCP affords.

The decision to join a CCP is not one to be undertaken lightly, but for many it is the best way to secure access to capacity for the business they simply must execute.

This market overview is the first in a series by LCH, looking into the effects of current and expected market evolution for securities financing markets. To find out more, contact lchsales@lseg.com.