What Does the Future Hold for General Collateral Repo?

LCH The Markets' Partner

RepoClear

As changes in the macroeconomic landscape and the shift in central banks' monetary policies start to be reflected in the market, LCH SA's Emmanuel Rolland, COO RepoClear, Collateral and Liquidity Management (CaLM), and Olivier Nin, Head of RepoClear & CaLM Risk, discuss the benefits and future role of LCH's €GCPlus General Collateral product.

The GC repo rate is the interest the seller of the securities pays to the buyer in the repo transaction in exchange for the cash lent.

01. What is a General Collateral repo?

Emmanuel Rolland (ER): General collateral (GC) comprises liquid securities that can easily substitute one another and therefore trade in the repo market at a similar rate, which is known as the GC repo rate. The GC repo rate is the interest the seller of the securities pays to the buyer in the repo transaction in exchange for the cash lent.

GC repo transactions are executed without the designation of specific securities as collateral. This means that it is the supply and demand of cash, rather than a specific security, that drives the repo rate.

02. Who are the key market participants trading General Collateral repo, and why do they trade it?

ER: GC is a powerful funding tool used by repo trading and treasury desks at banks, corporate treasurers and investment managers — entities that all hold large amounts of cash, corporate and government bonds, or both.

Market participants that hold substantial amounts of liquid bonds can turn collateral into cash, and cash holders can lend cash and earn interest, while receiving a basket of securities with predefined risk criteria.

Cash lenders can specify the GC basket of collateral they are prepared to receive, and an independent triparty agent manages the allocation and settlement of collateral on their behalf.

03. What is LCH's General Collateral repo offering?

Olivier Nin (ON): LCH SA brought its GC product — €GCPlus — to the market in 2014, in partnership with Banque de France and Euroclear. The product provides the ability for users to trade and clear standardised general collateral baskets, and to choose between two baskets. The first basket contains approximately three thousand very high-quality bonds, and the second basket around six thousand investment-grade European Central Bank (ECB) eligible bonds.

04. How is central bank policy affecting the use of GC products?

ER: As GC products are market funding tools, there is a strong negative correlation between the availability of cash in the market and their usage. The dovish monetary policies applied by several central banks after the global financial crisis had a significant impact on the appetite for GC products. Years of quantitative easing and bond buying programmes generated excess levels of liquidity, resulting in market participants turning away from GC products for many years.

05. What does the future hold for €GCPlus following changes to central banks' monetary policies?

ON: In the last few months, central bank monetary policy has shifted in a concentrated effort to address global inflationary pressures. Interest rate increases and the start of quantitative tightening are expected to remove liquidity from the market. Market players will therefore need to be ready to access alternative funding solutions.

In addition, the restraint of the targeted longer-term refinancing operations (TLTRO) favourable interest rate conditions, and the option of early repayment offered by the ECB to banks in an effort to tackle inflation, is expected to have a significant impact on GC products. The ECB is hoping that banks will hand back funds in order to avoid paying extra interest costs. Naturally, we should expect to see further demand turning to the overnight market, stimulating activity in €GCPlus trading.

06. With more flows expected in €GCPlus, what is your key offering that will attract market participants?

ON: At LCH SA, we have been anticipating the changes in the macroeconomic landscape and increase in appetite for GC products. With that in mind, we have delivered a set of continuous improvements to €GCPlus. The reshaping of the product has been carefully planned to answer the market's need to simplify trading, promote netting and offer one point of access to the largest cleared repo pool in Europe.

At LCH SA, we have been anticipating the changes in the macroeconomic landscape and increase in appetite for GC products.

With the extension of the trading cut-off time for €GCPlus same-day trade settlement, we offer our members greater flexibility durwing the day to manage cash and collateral positions.

Additionally, the simplification of allocation limits on the collateral allocated into €GCPlus transactions allows members to fund a wider range of portfolios, offering more flexibility.

Most critically, in July 2023 (subject to regulatory approval), LCH SA will be merging its core RepoClear service with €GCPlus to create a single service, removing the silos in which the two services currently operate. €GCPlus activity will now be merged with the €3.3 trillion RepoClear liquidity pool at LCH SA to unlock more netting opportunities for our members, establishing a full offering under one umbrella, and fostering quick and easy access to secured liquidity.

Members will benefit from cost reductions through the payment of a single default fund and decrease in margins. The addition of €GCPlus to the RepoClear service can lower initial margin requirements through further diversification and offsetting of positions. In parallel, operational efficiencies will include the introduction of one set of margin calls and reports across the two services.

Within the merged service, members will be able to easily lend specific securities and recycle the cash proceeds into €GCPlus, thus reclaiming their asset inventory, in one single ecosystem.

07. How are you planning to support the anticipated increase in appetite of the market for GC products?

ER: The shift in the macroeconomic landscape is just one of the factors expected to trigger an increase in the use of GC products. Importantly, in June 2023 the end of the pension scheme arrangement (PSA) exemption for the clearing of interest rate swaps will naturally increase the focus on the GC market.

PSAs will be faced with increased cash requirements in order to cover the CCP variation margin calls resulting from their cleared interest rate swap activity. This increased need for cash can be met by using cleared repo. LCH SA RepoClear can serve as a channel for PSAs to gain access to the largest Euro liquidity pool, thus allowing them to transform collateral to meet cleared interest rate swap variation margin calls.

One of the vehicles for this transformation will be GC products, as these provide an operationally simple and efficient way to raise liquidity. Furthermore, the cleared repo liquidity pool has demonstrated strong resilience and stability during recent market stress, allowing members to safely access liquidity, even when it becomes scarce in the uncleared world.

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But how can PSAs access cleared GC repo? To address this, LCH has developed a Sponsored Clearing model that enables pension funds and insurance companies to benefit from direct CCP membership and access to liquidity, even during periods of stress. Currently, 32 funds are benefiting from access to RepoClear's Euro and Sterling liquidity pool.

Recent events in the UK Gilts market and the 'mini' banking crisis are examples of a stressed and uncertain market facing increased volatility. The need to bring all market participants together in the same liquidity pool is becoming more apparent. At RepoClear SA, we are working to further increase access to the CCP base by extending the Sponsored Clearing model to a wider range of investor types, from regulated to more leveraged market participants. In parallel, we are enabling key funding providers, including selected supranationals and central banks, to join our pool and provide liquidity, so that market participants can navigate periods of severe market stress safely.

To find out more, contact lchsales@lseg.com.