Tapping into new liquidity pools

EUROPE'S MARKET FOR TRI-PARTY REPOS IS OPEN FOR BUSINESS AND LOOKING FOR CUSTOMERS, BUT APPETITE AMONG CORPORATE TREASURERS IS WANTING, SAYS OLIVIER GRIMONPONT

The European repo market's need for new blood was underlined in the latest semi-annual survey of repo business conducted by the International Capital Market Association's European Repo Council (ERC). Issued in September, the ERC study reported a market size of €5,612bn, based on the amount of repo business outstanding on 10 June 2015, a fall of 2.9% from 12 months previously.

This might not look like a market in crisis, but repo is certainly a market in flux. The ERC itself noted both extraordinary positive factors – strong bond issuance in response to low interest rates, excess liquidity derived from the European Central Bank's long-term refinancing operation and quantitative easing initiatives, as well as increased demand for high-quality collateral arising from the requirements of Basel III and the European Market Infrastructure Regulation for sell-side and buy-side firms, respectively.

On the other hand, forces dampening repo activity include Basel III's leverage ratio and net stable funding ratio, which tend to reduce the profitability of repo market activity, while the Central Securities Depositories Regulation and the Bank Recovery and Resolution Directive also pose challenges to secured lending business.

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Alternative liquidity

Speakers at Euroclear's Collateral Conference made it clear that liquidity from non-traditional sources had a crucial part to play in Europe's evolving repo market. Specifically, large corporates and other entities structurally long in cash (such as insurance firms and pension funds) have the assets available to become regular and substantial counterparties to banks looking to use their securities as collateral to raise cash. They may have the assets,

but do they have the appetite and capacity to meet rising bank demand for long-term cash from non-financial counterparties?

Certainly, corporate treasurers have reservations about European Commission proposals that require money market funds to be priced on a variable net asset value basis; they are also sensitive to the counterparty risks and costs of placing more cash on the balance sheets of banks, some with lower credit ratings than themselves. But they're not yet ready to embrace repo.

The latest ERC survey shows a continued rise in the share of directly negotiated transactions, reflecting a move away from low-margin, commoditised interbank transactions towards higher-margin, customised client business. However, the share of tri-party repo business – often considered a benchmark for non-traditional repo activity as this tends to be intermediated by tri-party agents – fell to 10% from 10.2% in June 2014, while the outstanding value reported directly by tri-party agents was also lower.

This hardly suggests overwhelming appetite, which is unsurprising in a low-interest-rate environment. Nevertheless, structural barriers to non-traditional repo market participation can be removed or at least lowered. In particular, there is great scope for simplification and automation of workflows, which will in turn improve transparency and capacity, thereby breeding a level of familiarity and comfort, which is vital if corporates, insurers, asset managers, etc, are going to become a permanent and meaningful presence in the repo market.

Already, we see corporates that started off in the repo markets conducting only very vanilla transactions now beginning to go further along the curve in pursuit of yield; for example, accepting equities as collateral, or agreeing to longer time horizons, and generally being open to innovation. This openness is built in part on relationships, but also on transparent and easy-to-use workflows. Industry efforts towards standardisation and automation of information exchange are important in this respect, particularly when aimed towards easier monitoring of collateral valuation and transaction pricing.

Overcoming the challenges

But a fundamental prerequisite of successful long-term participation in the repo market is access, ie the freedom to select counterparties as and when interests coincide. For banks, this is facilitated by long-standing bilateral relationships underpinned by a Global Master Repurchase Agreement (GMRA), but for newer participants the in-house legal expertise to manage these contracts is not necessarily available, presenting a major administrative hurdle. We have made a contribution to wider repo market access by developing a standardised GMRA that can be used by non-traditional market participants to transact with all repo market participants. Such initiatives will take time to build momentum, not least because banks are used to negotiating terms with individual counterparties, but there is a level of confidence that initiatives such as the standardised GMRA will continue to gain market acceptance, as banks, too, look to knock down the hurdles to broader market participation.

Transparency and access are also key themes from an internal perspective. While corporates will need accurate and timely intelligence on their upcoming cash needs when committing to the repo market, so institutional investors must be fully aware of the changing mix of assets within their portfolios and managed accounts. Buy-side firms that are long in cash naturally – or have a suitably liquid asset pool – may wish to leverage this situation to obtain high-quality liquid assets via the repo markets to support their OTC derivatives positions at a central counterparty. To do this, however, requires considerable workflow and technological coordination, compared with existing standard practice.

As such, for firms that do not already have a repo desk or sophisticated collateral management capabilities, the barriers to effective repo market participation might be as much internal as external. A degree of comfort and familiarity with the trading protocols and mechanisms of the repo market is also required to optimise its potential. Asset managers are used to trading equities and futures largely electronically, while dealing in OTC instruments, such as bonds and swaps via voice-brokered channels. Less frequent market participants will inevitably be used to more manual processes.

Existing electronic trading platforms in the repo market have largely been developed to trade fairly commoditised transactions between banks. As such, only now are they beginning to respond to demand for a wide range of functionality as non-banks assert their presence.

Moreover, MiFID II is imposing pre- and post-trade transparency requirements on a much wider range of instruments, adding further momentum to efforts to automate and standardise repo market activity. This means dealing with counterparties on a bilateral, heavily negotiated basis with non-standard terms likely to become a thing of the past. Clearer indications of interest and greater certainty of trading – delivered by standardised, automated platforms – will increase the appetite and capacity of non-traditional repo market participants to the benefit of all.

We are very much at the start of the journey towards a new repo market. Uncertain regulatory and macroeconomic conditions may at times slow the rate of progress. But if we continue to keep talking and keep shining a light on less transparent and more complex processes, the repo market will attract sufficient diversity and liquidity to meet the needs of a wide range of participants.

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