Navigating the repo waves

Industry experts give an insight into the main challenges the market faces today, including compliance with evolving regulation and managing cyber risk. But how are they navigating these waves of change?

What trends have you seen in the European repo market over the last year?

Godfried DeVidts: Implementation of mandatory clearing obligations contained in European Market Infrastructure Regulation (EMIR), and the Dodd-Frank ruling, and associated margining requirements for over-the-counter (OTC) derivatives, increased the demands for collateral and have led to increasing participation in the repo market by insurance companies, pension funds, and asset managers from the 'shadow banking' system.

Frank Gast: As the European Central Bank (ECB) is buying up a significant amount of high-quality liquid assets (HQLAs) as part of its asset purchase programme (QE), a shortage of bonds available for securities financing arises.

Collateral shortage and bank regulations for liquidity have caused a significant increase in demand for HQLAs and increased activity in securities-driven financing markets, including special repo, as well as securities lending.

Since the ECB reduced the net purchases of the asset purchase programme from a monthly pace of €60 billion to a new monthly pace of €30 billion starting in January this year, a stabilisation of volumes in the cleared cash driven repo market has been observed.

In addition, several pension funds and asset managers are in the final steps of onboarding to our 'Select Finance' offering in order to raise cash in our interbank market via central counterparties (CCPs). The new Eurex Select Finance model will enable buy-side clients to trade fully flexible as cash provider and cash taker. Select Finance is designed to accommodate buy-side needs, specifically those of pension funds and asset managers, for variation margin funding.

What opportunities do you see for investors and repo traders?

Gast: New regulatory requirements, such as Basel III, EMIR and Liquidity Coverage Ratio, substantially increase cost for banks in offering client clearing, either directly or indirectly. In order to enhance capital/balance sheet, margin and collateral efficiencies, sell and buy-side participants need to look for advanced CCP models.

With the introduction of new buy-side offerings infrastructure, providers, like Eurex, broaden their target group by enabling clients from outside the financial sector to participate in these markets.

DeVidts: When deciding which investments are right to pick, investors should be carefully considering whether or not they can later raise cash against them—equities, for example, are not eligible for CCPs or for central bank financing. This is nothing new, but it can be advantageous to invest in securities which have a deep liquid market or are easy to liquidate.

As for repo traders, although they still face balance sheet restrictions they have benefitted from the re-pricing of the repo product over the past few years. As a consequence, if mixed with other business within their firm, the repo product has become relatively attractive again. Repo has proven to be resilient but it now has to be seen as part of the overall function of collateral management within financial institutions.

What do you think are the top three biggest challenges for investors and repo traders?

Juliette Kennel: In this context, the three main challenges we see are compliance with evolving regulation, managing cyber risk, and ensuring the harmonisation and standardisation is in place to enable the industry to really take advantage of new technology.

On the post-trade side, the biggest challenge for investors and repo traders is probably understanding the impacts of new regulation and ensuring back-office operations are in place to comply with the new requirements.

DeVidts: The stability of the underlying assets is an ongoing concern. To take a current example, there is a risk in emerging markets, such as

Turkey, which may spill over into other markets. We should also watch out for the unwinding of QE, specifically because the list of eligible assets acceptable by central banks will be curtailed over time.

There are some major challenges ahead linked to the mandatory buy-in regime being introduced by the EU Central Securities Depositories Regulation. This will create perverse behavioural incentives, which will likely include increased volatility in markets—especially where there are identified short positions—and challenge the ability of participants, especially from the buy-side, to react quickly to the situation.

Gast: Regulatory requirements arising out of Basel III, Central Securities Depository Regulation (CSDR) or the Securities Financing Transactions Regulation significantly add to the cost of capital required to run a repo book and are assumed to reshape the structure and dynamics of repo markets.

Brexit, US politics and elections in the European area create volatility over financial markets and lead to a flight-to-quality towards core European markets. Given the role that London plays in the repo market, where a lot of the collateral comes from core investment banks, Brexit may have a significant influence on the repo market in the coming year.

How could the repo market benefit from innovation and technological advancements?

Kennel: Advances in technology can doubtlessly benefit the repo market—whether in optimising or in automating processes or in gathering and analysing data—ultimately facilitating greater collateral efficiency and mobility. To reap the benefits of these advances, however, standardisation is going to be key.

While distributed ledger technology might bring a number of business benefits, as with any technological solution the data, processes, inputs and outputs will need to be properly standardised.

DeVidts: Financial technology solutions may, at last, overcome the problems with the legacy settlement infrastructure of Europe, which has not thus far been solved with TARGET2-Securities implementation.

There are still too many CSDs remaining in the Eurozone, with no rationalisation in settlement yet achieved, making it ever more expensive, and still complicated, to effect settlement completion. There are huge opportunities here to reduce the hidden costs of the settlement.

Gast: Innovations in the area of blockchain, cloud computing, machine learning, robotics or artificial intelligence may be implemented and used to mitigate inefficiencies in the European repo market.

Deutsche Börse Group is currently working on a blockchain-based collateral swaps market to mitigate the collateral mobility problem across custodians. With the implementation of bank regulations for liquidity, mandatory clearing and margin requirements for OTC derivatives, efficient HQLA portfolio management has become critically important for institutional treasurers.

How have electronic trading platforms affected transactions?

DeVidts: Electronic trading platforms are helpful in achieving well-organised trade execution. This is currently directed towards CCP cleared transactions, but given the increasing use of non-government bonds, electronic trading platforms could also help to deliver faster and safer markets for bilateral trades, once the multiple settlement channels are satisfactorily streamlined.

Gast: Electronic trading is creating many market participants, improving market quality in normal times, lowering transaction costs and segmentation.

Electronic trading providers, such as Eurex Repo, aim to provide possibilities for market participants to increase efficiency in capital and liquidity management. One initiative to reduce the number of outstanding trades is compression as a new trade type. Compression can be used to tear up a trade by partially or wholly offsetting positions against other positions held by that financial institution.

In the next two years, what developments do you expect to see in the European repo market?

DeVidts: I expect to see larger outstanding volumes and wider participation in the market. And there may be a growth in term trades, driven by the new behavioural incentives, which will be created by the introduction of new net stable funding ratio liquidity requirements.

Undoubtedly there will also be more electronification, including in emerging markets, leading to more efficiency. I expect digitisation to further enable the trend, which we are already observing, with business to business transactions becoming the norm and diminishing interbank transactions. I hope that this will lead to the clear recognition of the value of the repo product.

Kennel: In both markets, we'd expect more budget and investment being allocated to handle regulatory and cyber issues, which unfortunately is not so much a licence for industry participants to develop new business lines, but rather a requirement to defend their 'licence to operate'.

On the collateral management side, it will be interesting to follow the evolution of the ECB platforms and to see how EU-based changes will impact on other markets. This will be especially critical for global firms acting in multiple markets and jurisdictions.

Gast: The European repo market will inevitably be dominated by regulation. Given the market's experience with EMIR, SFTR will likely be a drag on the market for the next year or so, with firms switching a lot of resources to deal with that. **SLT**