Prudential Regulation (excluding NSFR) - Impacts on the repo market for safe assets

Harry-David Gauvin

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Liquidity Coverage Ratio (LCR)

<u>High Quality Liquid Assets / Net Outflows over 30 days under a liquidity stress scenario</u>

- Banks hold a sizeable (€3.9T!) stock of cash and HQLA securities for LCR purposes. Both can be repoed.

- Total bank HQLA holdings have grown enormously over at least the last four years, but most of the increase has come from growth in excess reserves rather than securities.

- The LCR means banks have little appetite for short term cash (viewed as such by the LCR's behavioural rules) including particularly non-bank financial institution deposits. These counterparties may need to deploy their cash elsewhere, including the repo market.

- ICMA Repo Survey – December 2018 survey (undertaken semi-annually): "Remaining maturities over one month up to three months recovered, possibly also a seasonal change but perhaps partly driven by collateral transformation to meet end-year regulatory liquidity ratios" https://www.icmagroup.org/assets/documents/Market-Info/Repo-Market-Surveys/No-36-December-2018/ICMA-European-repo-market-survey-number-36-conducted-December-2018-040419.pdf

- Market responses include 31-day evergreen trades and collateral swap trades.

What is a "safe" asset?

- Although there's a correlation with LCR HQLA, not everyone will see the same assets as "safe".
    - Domestic bonds versus foreign bonds?
    - BTP v Bund correlation – only legislators think these are the same asset.
    - Non-bank participants don't view assets through an LCR lens.

Leverage Ratio

Tier 1 Capital / Total exposure

- Since 2015 EU institutions have been required to publicly disclose their leverage ratio and its components, and in December 2017 the Basel Committee set a 3% provisional target ratio.

- Interaction between the LCR and Leverage Ratio. The LCR prevents a short term deposit being used to fund a loan. Instead it is deployed into HQLA, creating leverage.

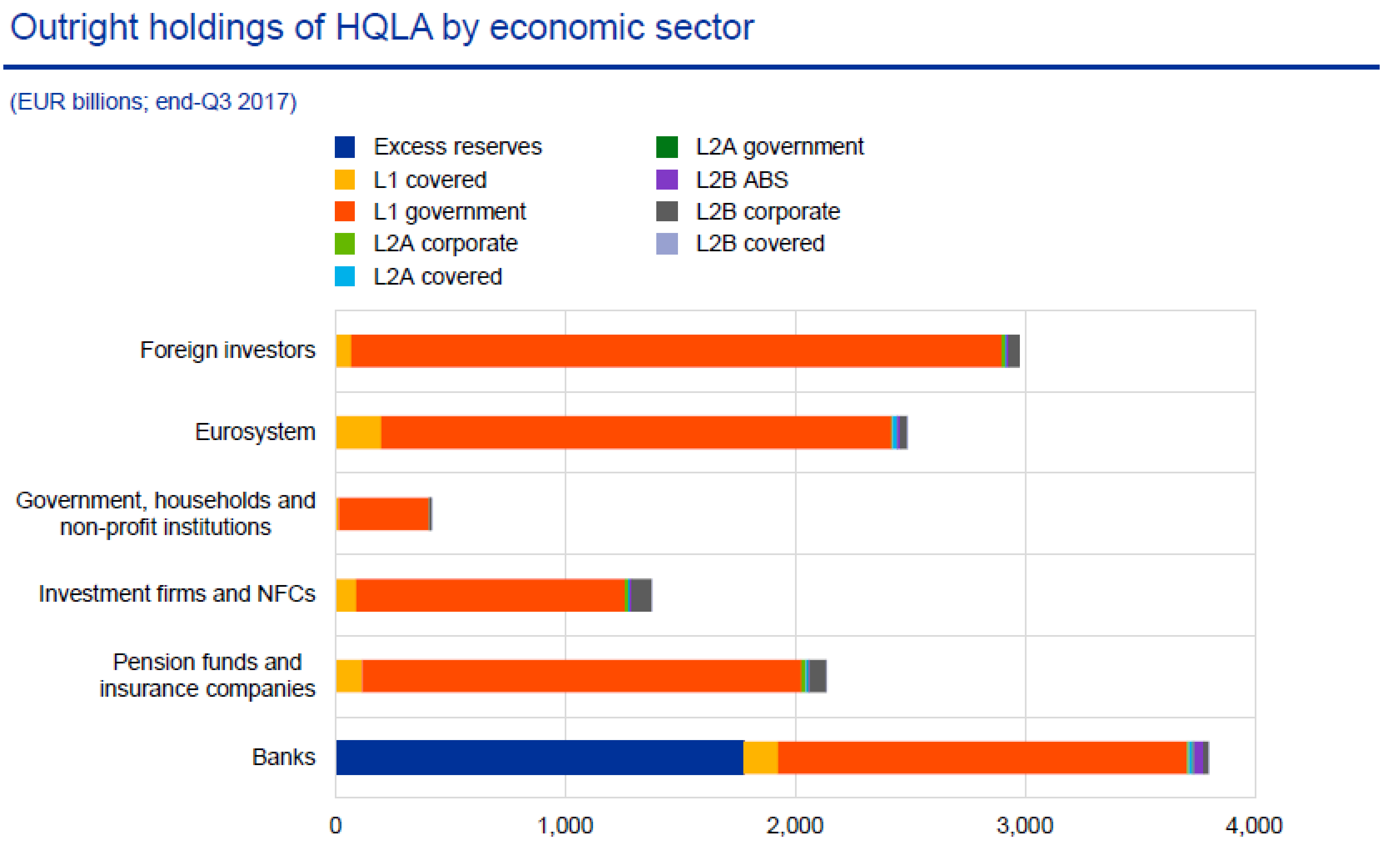
- "Netting [rules have] resulted in a much greater use of central counterparties (CCPs). Eurosystem contacts report a wide difference in the pricing of trades cleared bilaterally and those cleared through CCPs – sometimes in the tens of basis points." Yves Mersch 2017 https://www.ecb.europa.eu/press/key/date/2017/html/sp170126.en.html

- "We find that gilt repo liquidity worsened during the period when UK leverage ratio policy was announced [and] that gilt repo liquidity has become less resilient. However, evidence from heterogeneity in dealer behaviour is inconclusive regarding a causal link between leverage ratio requirements and the reduction in market liquidity.". https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2017/the-leverage-ratio-and-liquidity-in-the-gilt-and-repo-markets.pdf?la=en&hash=71FA6253382B0141771D5C8FC6C8A1AE552CE6F3

- 2015 ICMA paper: "The Leverage Ratio, where it is being applied, is having the most profound impact on the repo market, to the point where repo is becoming unprofitable as a traded product."

- Market responses include collateral swap trades (e.g. bond vs bond removing the two cash legs), measures to increase netting, and reduced activity on balance sheet reporting dates.

HQLA by Sector



https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op218~801632b377.en.pdf?044f2bab998318e649ca0bc899b3095c

Overall repo market demand / supply factors

Increased supply of cash/ demand for collateral

↑ Increased cash supply from ECB (against non-HQLA assets)

– Non-banks (no central bank access) seeking to deploy cash – poor rates offered by banks on NBFI cash due to LCR treatment interplay with leverage

– Less demand for short term cash by banks due to LCR (either unsecured or by repo)

– CCP's own cash deployment in the repo market

– Banks no longer willing to lend interbank on an unsecured basis (but little demand anyway)

– EMIR collateralisation requirements

Decreased market supply of safe collateral

↓ Rating downgrades and perception of deteriorating quality of some sovereigns

↓ ECB's Asset Purchase Programmes

↓ LCR requiring an accumulation of HQLA on bank balance sheets (outright or term reverse repo)

↓ Reduced appetite to repo out liquid asset buffers due to leverage ratio requirements and NSFR penalty

↓ RWA requirements push towards holding "safe" collateral

Forward-Looking Factors

Evolving Pillar 2 Prudential Liquidity Requirements

- Prudential regulators are increasingly requiring granular views of stressed liquidity both below and beyond the LCR 30 day time horizon.
- This topic goes by different names, such as "Low point analysis", "survival horizon", and "Cashflow mismatch reporting". Most notably PRA110.
- The impact is that transactions just inside, or just beyond 30 days favourably impacting LCR may fall foul of other requirements.
- Repos may becoming interesting for managing the timing of short term cashflows and smoothing out assessed lowpoints.

https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2019/pillar-2-liquidity-sop-update-june-2019.pdf?la=en&hash=78618B0A466B17BCF86952AAD06AC14AEE3E4FDE

Future Tiering?

"Central banks' monetary policy implementation can also increase incentives for reserve holders to carry out repos if the central bank introduces tiered remuneration for reserves, as was implemented by the Bank of Japan and the Swiss National Bank (SNB). In jurisdictions with tiered remuneration, banks typically earn a relatively high rate on reserve balances beneath some threshold and a lower rate on reserve balances exceeding such a threshold. This creates an incentive for banks that hold fewer reserves to borrow reserves via repos from banks that hold more reserves, in order to increase the rate that they receive on their overall reserve balances."

BIS Committee on the Global Financial System, paper 59, April 2017. https://www.bis.org/publ/cgfs59.pdf