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Repo and market making: what trends and possible actions in the current regulatory context?

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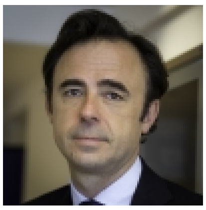

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Objectives of the session

This roundtable discussed the current and future trends of capital market activities, notably repo markets and market making activities, their underlying drivers and what impacts these evolutions may have on markets and on the broader economy. The regulatory approach that was needed for such markets was also addressed, as well as the means needed to monitor these activities at a European and global level.

Executive Summary

Current and future trends and underlying market drivers

Repo and Securities Financing Transactions (SFT) were essential for developing capital markets and achieving the objectives of the Capital Markets Union (CMU). They allowed market participants to access secured financing and were a crucial tool for the functioning and the liquidity of secondary markets.

The European and US repo markets were similar in size, but there were some differences between the two markets. The tri-party market, where the post-trade processing of the transaction is outsourced to a third-party agent, was much larger in the US (50% compared to about 10%). In Europe, roughly 25% of transactions were related to equity collateral, compared to around 10% in the US. The US repo market was dollar-denominated, whereas there was a range of currencies in Europe. The US also tended to be an overnight market, whereas in Europe there was a laddered tenor structure.

There was liquidity in the European repo market, but costs had increased and the longer term prospects were unclear. There was anxiety lest reduced liquidity in the SFT market could increase the impact of a possible market dislocation. Vulnerability to fire-sales and run risks had been exhibited in the US repo market during the crisis. The Tri-party Repo Infrastructure Reform had since established rules that mitigated these risks to a large extent, but post-default fire-sale risk remained to be tackled.

Looking at the Bund market in particular in Europe, there was no decline in activity, but tickets were bigger and volatility and failures had increased. However, the Bund market was never a market of primary dealers.

The repo market was evolving towards higher-quality underlying collateral and relatively standardised terms of price and maturity that could be easily understood and modelled for risk management purposes.

Regulation and monetary policy were the two main drivers of the on-going trends

Regulation had had positive and negative impacts on the repo market. Basel requirements such as the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR) and the Supplementary Leverage Ratio (SLR) had increased costs but also made the market safer; moreover demand for secured financing was expected to increase. Markets were neither drying up nor increasing. The impacts of these requirements however had to be examined at the business line level a speaker pointed out. Since greater capital had to be applied to some business lines, bank managers would naturally move capital to those with a greater yield and within these business lines to the most profitable clients who were also the most transaction-oriented ones. The other clients, such as pension funds, insurance companies and long-only money managers may end up having less access to the market and higher prices as a result.

Prudential requirements would also impact traditional market-making activities. Alternative providers such as HFT firms were entering the market. MiFID II would impose obligations on those providers if they acted as market-makers, with the objective of levelling the playing field. MiFID II would moreover fundamentally change the way non-equity markets operated.

The monetary policy of the ECB also had a deep impact on the repo market, affecting pricing and the length of maturities. Pricing at present was distorted. It was no longer determined by demand and supply, but mainly by the deposit rate and the view taken towards the future actions of the ECB. At present about 10% of outstanding debt was being bought by the Eurosystem but this had a major influence on market prices; it also helped to maintain the liquidity of the market. More clarity was also needed on the securities-lending programmes of central banks. The ECB and the Eurosystem were also be part of the solution, a panellist noted, developing market infrastructure, encouraging tri-party repos and lending to the market, all of which contributed to increasing the velocity of collateral, which was essential for repo.

Way forward and possible actions

A possible regulatory pause

Some panellists suggested that given the current uncertainty in the market, caution was needed. It was suggested that the best that could be done was to take a regulatory pause and to develop a clearer view of how the market was functioning and how pricing was determined, in order to decide the best course for action. A pause would also help to see how much price transparency and depth there was in the market, particularly in relatively standardised trades and instruments.

Other participants considered that there was no need for a regulatory pause. Some issues needed to be addressed and it was preferable for analysts to go over the data urgently. Another suggestion was that regulation – i.e. the SFT Regulation (SFTR), the CSD Regulation (CSDR) and secondary legislation regarding CCPs - could be a way around the obstacles to increasing collateral velocity.

Adopting a notion of ‘do no harm’ was proposed by a panellist. As long as the impact was not known, care should be taken regarding the speed of implementation of new changes. A continuous monitoring of market trends was also necessary. More importantly, if significant issues were identified during the implementation of a regulation, a ‘reverse gear’ mechanism should be available in order to stop or amend the process. This was the type of approach that was intended with the Call for Evidence, which should be used more systematically across legislations. The SFTR would also help to better measure trends.

Central clearing

Developing the central clearing of repo was also proposed. This could alleviate some of the balance sheet constraints of dealers. There would be netting benefits which could release more assets in the market. There might also be benefits for financial stability, potentially reducing the risk of fire-sale under stress. Central clearing was however not a panacea because it increased risk concentration. The insufficient transparency for participants of their own risk models associated with CCPs that were potentially under-capitalised, was a concern that clearing members generally had with CCPs. In addition with repo the underlying assets would have to be disposed of in case of default. Further standardisation of products and of underlying assets would be needed in this perspective. Issues related to leverage ratio rules would also have to be further assessed.

Haircut floors

The FSB had tabled a proposed framework for haircut floors, which Europe would decide in 2017 whether to implement. Haircut floors aimed at making markets more resilient by addressing contagion and procyclicality risks and excessive leverage. This was a measure that would be desirable, but required further modelling and analysis in order to understand how it would be implemented. There was indeed much variety in the market (types of collateral, tenors) and it seemed difficult to reconcile interests in this perspective. It was moreover suggested that, although the FSB proposal was useful, it was perhaps not useful at present. Developing benchmarks and metrics would in any case be helpful.

Monitoring repo and SFT activities

There were many data gaps in securities financing markets at the EU and global levels.

SFT data that should be available in the EU following the implementation of the SFTR was critically important to monitor the on-going trends in the market, assess the impacts of different factors, evaluate whether there was a failure in the market and determine which tools could help. A challenge was that SFT data was spread out over multiple databases in Europe. A project had therefore been launched at the Eurosystem level to consolidate those databases into one that could be used by the ECB for supervision.

Another issue was that the ECB monetary actions were currently masking the underlying trends in the SFT market, which required further assessment. The cumulative impact of the different regulatory measures that were going to affect the SFT market in Europe also needed analysing which required modelling.

Some modelling had been done in the US, but data was still missing; there was some aggregate information regarding securities lending, but more granular and detailed information was needed, particularly regarding bilateral repo transactions. The OFR was collaborating with the Fed and the SEC to conduct pilot data collections in the bilateral repo and securities lending markets, which were due to become permanent. Establishing a partnership between regulators and the industry was extremely important and valuable in order to define from the start what data represented and how to collect it. Moreover it was essential to standardise the data using standard legal entity, product and transaction identifiers. Supervisors were collaborating at the international level in order to understand the differences across markets, the interconnections and the transmission mechanisms of shocks.

There should also be a specific focus on collecting liquidity data regarding market depth or the time it took for a portfolio to be liquidated. Liquidity measures indeed lacked the history of data supporting them that those related to market or credit risks possessed.

Detailed Summary

Introduction

The chair outlined the topic of the session. There was a project with the Capital Markets Union (CMU) to develop capital markets and market-based finance more generally. This would be difficult without well-functioning repo and other securities financing markets. Those markets allowed participants to access secured funding, and were an essential tool for the functioning and the liquidity of the secondary market and for the funding of the economy.

During the crisis, regulators and supervisors had encountered difficulties in identifying the emergence of risks in the area of securities financing. This had particularly been due to the lack of timely and comprehensive data. In Europe, attempts had been made to address this with a recently adopted legislative proposal: the Securities Financing Transactions Regulation (SFTR). This legislation was essentially about bringing transparency to those markets, especially for regulators. The chair wondered whether the transparency that would be provided would be sufficient to address the issues that had been identified and whether the data requirements were appropriate. Haircuts had been proposed to mitigate the risks associated with secured financing operations. There were also concerns about the operation and liquidity of such markets following a significant drop in activity.

There were three central topics for this roundtable: the current and future trends of capital market activities, notably repo markets and market-making activities, as well as the underlying drivers of these trends; the possible impacts of these trends on markets and on the broader economy; and how these developments were monitored at a European and global level.

1. Current and future trends, and underlying market drivers

Current structure and status of the market in the EU and the US

An official noted that the US and European markets were similar in size. Looking at repo rather than reverse repo, the European market was around $ 3 trillion, as best it could be measured by the International Capital Market Association (ICMA) survey, whereas the US market was $ 3.4 trillion from the measurements of the New York Fed.

Markets were however different in the EU and the US to a certain extent. The tri-party repo market (cleared by two clearing banks in the US) was much larger in the US than in the EU.

In terms of collateral breakdown, in Europe roughly a quarter of transactions were related to using equity collateral, whereas in the US the figure was only about 10%. That was dynamic and changing market however.

As might be expected, the US repo market was pretty much a dollar-denominated market in terms of currency composition, whereas in Europe there were a variety of different currencies. This meant that when characterising these markets, they needed to be disaggregated and how they were traded examined. There might only be small shares in some currencies, but nonetheless the links and what was going on in the market needed to be understood.

Finally, the tenor in the US was different to that in Europe, reflecting what the ECB was doing with Targeted Longer-Term Refinancing Operations (TLTROs). The US market tended to be an overnight market, whereas in Europe there was a laddered tenor structure, whereby the funding had buckets of tenors that went out longer in maturity.

A central banker said that, looking at the German repo market, and specifically the one related to the Bund, there was not a decline in activity. There were bigger tickets, a little more volatility and more failures in delivery, which was an indication that the back-up by lending and arbitrage-driven repo activity had declined. It needed to be borne in mind, though, that the Bund market was never a market of primary dealers, though it was always an electronic market of many.

An industry representative added that there had been an increase in overall costs, and the quality of the underlying had not been increasing, because there was a tendency towards non-LCR (Liquidity Coverage Ratio)-eligible paper. There was liquidity, but there were some concerns notably in repo markets. Making money in the market was increasingly difficult and the long-term effects of that situation were unclear. There were, however, no panic signs that the market was drying up as senior unsecured debt had. These trends had been noticed and could increase potentially, making markets more difficult. They needed to be monitored very carefully so that secured financing did not dry up; there would be an overall trend towards secured financing, as banking was no safer for senior unsecured debt.

Current market trends and underlying drivers

Repo and Securities Financing Transaction (SFT) markets

An industry representative highlighted some drivers of the current evolution of repo and securities markets. One was regulation. Regulation had both a positive and a negative impact on the repo market: negative in the form of the Liquidity Coverage Ratio (LCR), which was a downside for the markets; on the other hand, secured financing had, in Germany, become more important given that unsecured financing had dried up. This was one of the visible trends: markets were not disappearing, but not increasing.

Secondly, the European Central Bank (ECB) had a deep impact on the market. It had at least two effects, the first of which was on pricing. Repo pricing was not oriented towards the market, it was not currently determined by the underlying and the supply and demand, but more by the view taken towards future actions of the ECB and the deposit rate. There was no short positioning at present, because there was only one buyer of securities, which distorted the prices. The other effect was that maturities were going out much longer. It was not clear how and in what way TLTRO II would be impacting, because TLTRO II operations had a maturity of four years from their settlement date.

A central banker added that there was one very special market-maker in the market (the ECB), which had one particular feature: it put only one-sided prices and was only buying. At present, in terms of the activity of the Eurosystem as part of the Quantitative Easing (QE), roughly 10% of outstanding government debt was being bought. Whilst this was not a huge quantity in absolute terms, it would have an enormous influence on pricing at the margin. This would overcompensate for the effects of the liquidity ratio of Basel III, and other regulation that was negatively impacting on the incentives of market-making. Presently, there was a QE-driven market that worked and was liquid, but there might be a little less professional arbitrage-driven repo activity than there had been.

The ECB and the Eurosystem were not only part of the problem, but also part of the solution, the central banker stressed. They did many things in terms of infrastructure, such as TARGET2 and TARGET2-Securities. Moreover, the ECB and the Eurosystem were facilitating the use of cross-border tri-party repos. Finally, the ECB and the Eurosystem were lending; they not only bought from but lent back to the market. The idea was to try and increase the velocity of collateral to the benefit of everybody.

An industry speaker stressed that the securities-lending programmes of central banks also had a big impact on these markets. They needed to be defined. As with regulation here was an unintended impact from not knowing what was going to happen with these programmes. Securities-lending programmes were not exactly regulatory, but they were very important for the functions of the market, and were up in the air in terms of what was going to happen.

An official noted that the on-going trends in the US and EU markets were different. Monetary policy was different in the two regions, which might affect what was happening in the repo markets. Legislation, such as the securities financing legislation (SFTR), had not been replicated in the US. There had been reforms in the US at the tri-party level in order to reduce counterparty risk, which had been helpful. This had made tri-party transactions safer but had also raised their cost. On a risk-adjusted basis, it could be argued that costs had not gone up, but clearly accounting for the risks had raised the costs, so some activity had shifted to the bilateral market, about which very little was known. Both of these markets were however extremely important for the functioning of the repo market.

Basel requirements (the Leverage Ratio, the NSFR and also the Supplementary Leverage Ratio (SLR)) had also increased the cost of doing business as well as making it safer. As a consequence, repo activity had become less attractive as a business for traditional providers, which was going to have an influence on how the markets functioned.

An industry representative emphasised that banks played a key role as intermediaries of risk, in “greasing the wheels” of the secondary market. When examining the recent Basel prudential regulations, although their application was quite appropriate at a broader bank level, there were “chilling implications” for certain business lines. The reason why banks were complaining to regulators was that there were clear winners and losers from an individual business line perspective. Since greater capital had to be applied to their business, with the Basel requirements, and more cost was associated with it as a result, some individual business lines had decreased returns on capital. Bank managers would naturally move capital away from the less profitable lines to others which had a greater yield. This required those businesses, in turn, to shrink and focus on a higher-yielding subset of their client base. But higher-yielding clients were by nature the more transactional-orientated clients. Therefore the less transactionally-orientated clients, such as pension funds, insurance companies and long-only money managers, would fall to the bottom of desirability amongst the client base. As a result, they would have less access to the market and their prices would increase. Some of these business lines affected by Basel rules were financing businesses, in repo and equity financing. Clearing was also specifically affected; cleared repo was an alternative, but it was boxed in. These developments led to a reduced ability to carry inventory in an efficient way.

A public representative explained that the European Parliament had passed SFTR in record time, with very few arguments and a unanimous vote. It had been a technical dossier compiled by a small number of people, without much political coverage. The impact of the cumulative legislation, including banking and market-based legislation, had not really been considered by the politicians behind the legislation. In some ways, there had been positive reasons behind this, and in others there had been a negative impact. If people did not understand what the unintended impact of different pieces of legislation was on a particular part of the market, they would de-prioritise it when it came to making decisions.

There was also some interplay between Basel capital requirements and MiFID II. Currently, the EU Parliament was implementing some major structural changes in the way that markets traded. When MiFID II would come into force in the non-equity space, it would fundamentally change the way that markets operated, with less incentive for some of the market-makers to participate in the traditional way, given the capital requirements imposed on them.

There was also a political issue. It had been decided not to introduce a definition of market-making in the MiFID II text, but the issue had been addressed under the high-frequency trading (HFT) rules, defining anybody claiming to be a market-maker as having obligations and therefore capital charges associated with their business. Now, they were trying to level the playing field between traditional market-makers, who had major capital charges under Basel, and other providers of liquidity such as HFT firms coming into the fixed-income space. These latter providers were structurally changing the market and there would probably be more of them, but they were trying to impose obligations upon them too.

It was not certain that politicians really understood how all of the moving parts of the market worked together. It was important that there were ways to monitor it. SFTR implementation post-2017 would at least give an idea of the depth of the market, and what role it really played. Hopefully that data would start to give an idea, and would come in advance of the MiFID II implementation, where trading obligations were fundamentally changed.

Possible impacts of these trends on markets and the economy

An industry representative said that on the market participant side, there had been an evolution of the market towards higher-quality underlying collateral and relatively standardised terms regarding price and maturity that could be understood and modelled. Modelling was important, because, as with every other financial instrument, repo had to be subject to models for value at risk

(VAR), stressed VAR and various other issues related to capital. The less standardised underlyings and haircuts were, the more difficult it was for any bank to build appropriate internal models. There was an incentive, then, from a risk management point of view, to standardise.

A public representative was concerned by the apparent contradiction between these ongoing trends in the securities financing market and the shadow-banking terminology being used on one hand and the objective of the CMU to encourage a market-based economy and a movement towards capital markets on the other. These evolutions of repo markets would also affect money market funds and collateral management tools. There was also concern that politicians did not have a clear position on these issues, as nobody had sat down and thought about the whole market and how to bring everything together on capital, structural changes to the market, and the players of the future. It was not clear that the existing players would be there going forward.

A policy-maker emphasised that the call for evidence launched by the EU Commission would help to identify these potential frictions, overlaps and inconsistencies in regulation. The problem was that there were different objectives, which were sometimes conflicting and required trade-offs. Developing a vibrant capital and repo market was important but there were other issues also such as ensuring financial stability.

An asset manager agreed that none of these issues and regulations could be looked at in isolation. There was a need to evaluate the outcome of that call for evidence and ensure that any inefficiencies pushing through the marketplace were addressed, in order to end up with a strong money-market business in particular which ensured that European markets could grow and help the development and delivery of the CMU.

Potential vulnerabilities stemming from on-going market trends

An industry speaker stressed that although the issues discussed in this roundtable were not necessarily a direct source of systemic risk, they probably laid the groundwork for sharper transmission of some dislocation in the marketplace. Once less fluidity was built into the markets, possible dislocations would turn out to be more troublesome. There was anxiety to see the results of the call for evidence and whether it laid bare some of the underlying effects of on-going regulations for certain business lines and marketplaces and whether some conclusions could be drawn as to what the best path was.

An official noted that it was important to step back and remember why some of the rules had been put in place, both the SFTR in Europe and the changes made to the tri-party market in the US. In the crisis, secured funding markets were vulnerable to fire sales and run risk, and some of those risks had been exhibited. Rules had been put in place to mitigate some of those risks - tri-party repo reform in the US had mitigated, to a large extent, pre-default fire-sale risk[1] - but post-default fire-sale risk still existed, and that was something that policymakers needed to address. In addition, most of the run activity had been in the bilateral market, but since that was a market about which little was known, more needed to be discovered. Gathering more information on this market would be helpful before making decisions.

2. Way forward and possible actions

A possible regulatory pause

An industry representative argued that much had been said about the pressures of regulation and issues with inconsistent regulation. The best that could be done was to take a pause, to at least see how much price transparency and depth there was in relatively standardised trades and instruments. That did not mean that everything should go to clearing houses, but that the volume of standardised trades could be measured.

Another industry speaker also felt that a pause was necessary, because there was no clear view at present on how the market was functioning and how pricing was determined with the on-going actions of the ECB. As mentioned further up pricing was not oriented towards the market at present, but more towards the deposit rate.

An industry speaker was also in favour of a timeout, as regulators and the industry were beginning to assess the interconnectedness and dependencies related to some of the alternatives, such as central clearing, where there were roadblocks e.g. in the application of current leverage ratio rules on client-central clearing. There were discussions ongoing with Basel and other regulators regarding some of the impediments that it caused, in order to find appropriate solutions.

A policy-maker considered that making a regulatory pause was not easy with the calls from the industry for fixing problems in the regulatory framework. The call for evidence could provide solutions for tackling these issues hopefully. Responding to an industry speaker who suggested that a pause might be a way to fix the problem, the policy-maker answered that regulation would eventually be needed in order to address the problems at hand and this would anyway create some uncertainty regarding the regulatory framework for market participants.

A central banker agreed that there should not be a regulatory pause. One of the issues regarding repos was to increase collateral velocity, which required better regulation to address the current obstacles. The SFTR was a wonderful piece of legislation which would help to increase collateral velocity, and more of this was needed. The Central Securities Depositories Regulation (CSDR) was helpful also. Moreover ESMA secondary legislation was needed to make the rules clear on how to bring positions to CCPs in order to make the best use of collateral. There should therefore be no pause, but better regulation geared towards higher velocity of collateral. A banker however noted that there was a suspicion that it might not improve.

A public representative believed that there was not a need for a regulatory pause, but rather for analysts to go over the data as urgently as possible in order to better assess the issues, because it was not clear that there was agreement as to what the problem was.

Central clearing

A central banker emphasised that the benefit of netting was enormous if everybody went to a CCP, central banks, government agencies and reserve management authorities included. The more came, the better the netting became.

An asset manager agreed that netting would release more assets which would be very welcome for users. In that respect, pauses on anything preventing that would be undesirable. From a money-market fund perspective, for the last nearly three years there had been a money-market legislative file not moving forwards. In some ways this had been good; in others it had been bad. Money-market funds were significant providers of liquidity into the marketplace, and users of the repo product and significant buyers of short-term bank, corporate and government securities.

Another industry representative concurred that there would be a trend seen towards CCPs and electronic counterparties. The standardisation called for needed to take place, and that would place more pressure on margins. There were many more trends going on, which could not be influenced so long as the market in Europe was distorted. Markets were not functioning in the way that they would in 10 years. It was necessary to acknowledge and be humble about what could be done in the market.

An official noted that there was a need to think about proposals designed to mitigate some of the risks associated with SFT. Part of the narrative in the US was that central clearing for repo would solve many of the problems. Certainly it would benefit the dealer community, because it would alleviate some of the balance sheet constraints. Additionally, there might be benefits for financial stability, in that it might reduce fire-sale risk prospectively under stress. However, before regarding that as a panacea, there should be some thought about it and facts procured to analyse what the benefit and the costs might be, because it may be that it would concentrate risks in places where they needed to be managed very carefully.

An industry player noted that when central-clearing risk had been discussed in the swap markets, the issue of a single point of failure had already been identified. More than that, the question was whether CCPs were adequately capitalised and subject to capitalisation standards comparable to banks. They were not. The lack of transparency for participants in CCP as to their own risk models was a concern for banks. In repo, there was an added concern, the speaker believed, which was that there were underlying assets which would have to be disposed of in the event of a default, and of a trade that would need to be unwound – which would then argue for standardisation of assets. If they went that way, it would not be possible to move the entire repo market, or even a significant part. It might be possible to move a part relating to certain high-quality instruments, which could help sovereigns, but it needed to be understood that market participants were not yet comfortable with all the other risks of CCPs before burdening them with repo. That would be the difficult part.

An industry speaker considered that there was potential opportunity to apply more products into a centrally cleared environment, which might or might not help the overall situation. If the aim was to promote more central clearing and the velocity of collateral, etc, then there was a need to address the issues related to the leverage-ratio rule and the fact, related to client-clearing, that it did not allow the offset of future exposure with the initial margin on deposit from the client. That was segregated specifically for that purpose.

A public representative stressed that there was much talk of regulatory requirements that were impacting the repo market, such as the clearing obligation and the LCR. However, these had not yet been implemented in Europe. They were still to come, yet discussion had already turned to their impact. There was experience in the US, where the SLR was causing major difficulty and potential offloading of clients from clearing members, because of this issue. There had been strong words from central bankers who did not believe that this should be done in Europe, and therefore when it was implemented account should be taken of the fact that the main obligation in Europe was to get and encourage central clearing, and that anything that discouraged it should be reviewed and perhaps not implemented in the same way as in the US.

Impact of prudential requirements

An industry representative stressed that there needed to be careful consideration of the application of the NSFR rules to the lending of certain securities. A basic example would be total-return swaps, which were often trafficked in by pension funds, money managers and long-only accounts. This might be how they achieved their core beta exposure to an equity market, and such swaps could be very short in duration, as short as three months. Under NSFR, there was a requirement to fund half of that inventory with over a year's financing, which raised the associated costs significantly and dampened the appetite to provide this service.

Another banker agreed that there were technical aspects to some of the rules which could be altered to the benefit of the depth of the markets.

The proposal for haircut floors

The chair noted that the Financial Stability Board (FSB) had tabled proposals by way of a framework for haircut floors in order to address contagion risks, procyclicality risks and excessive leverage. In the EU, it had been decided to take some time until 2017 to assess this and determine whether or not to implement the recommendations.

An official considered that haircut floors sounded great in concept to make markets more resilient but in practice were not easy to implement. That was because of the variety of types of collateral and different tenors, and the need to reconcile interests in the way markets set haircuts. This had been observed in the bilateral market and made it very complicated to think about how to set minimum floors. There were many ways to think about this through the cycle, such as minimum haircuts to take out the procyclicality which was intrinsic to the way markets set haircuts. This was something that would be desirable, but again required modelling and analysis in order to understand how it would be set.

A central banker noted that one criticism of the FSB was the timing. Whilst it was all useful, it was perhaps not useful now.

An industry speaker thought that it was helpful to have benchmarks and metrics, and the proposals for minimum haircuts, on the table. It was important for financial institutions to consider the merit of these things, and ultimately to provide data in order to get this
balance right. This was a very helpful debate.

SFTR measures

An attendee asked what the panel thought about unfinished business at the global level, in particular financial stability-inspired concerns about rehypothecation and reuse of collateral and chains of transactions, and where the regulation might be going.

A public representative answered that the way in which rehypothecation was defined was different under the UCITS, AIFMD and CSDR frameworks. Therefore, getting some consistency in definitions would be quite useful; this would help to make sure that rules were consistently applied to the same players in different pieces of legislation.

3. Monitoring repo and SFT activities

Modelling the impacts of regulation and taking them into account in the legislative process

A public representative considered that SFTR data was critically important, and was needed as soon as possible because at present they were quite blind as to the real trends in the market. If the ECB actions were masking the underlying trends, there was a need to find the measures and models that allowed access to the underlying data in order to assess the impacts of different factors and to evaluate whether there was a failure and if new tools needed to be considered. The nub of the problem needed to be identified, to work out what was happening, bearing in mind that there was a clearing obligation coming in in the summer, and that the CSDR was not to be implemented for another couple of years. There were many additional measures to come, the impact of which needed to be modelled and assessed on a cumulative basis, which had not yet been done in Europe. Lessons might well be drawn from the US sooner than this.

An official indicated that in the US, some of that modelling was being done, but this required data.

A central banker said that currently a lot of modelling was done on financial market infrastructure regulation and improvement in Europe. If banks were constrained in their activities, for example by Basel III, the next stop would be the funds industry. There was a need to make sure that when financial market regulation was designed, the funds industry could play a bigger role in that market infrastructure.

The public representative suggested that a notion of ‘do no harm’ needed to be adopted more widely. As long as the impact was not known, care should be taken around the speed of implementation of new changes. However, monitoring of the current market and future changes to the market was necessary. Data was critical for better decision-making, and whilst data was desirable ahead of legislation, it had often not been available. Most importantly, if things were gotten wrong during the monitoring process and a detrimental impact was seen, then a reverse gear was needed: a method of stopping the intervention and the harm. The Commission should be congratulated for their call for evidence, but this should not be a one-off. It should be an ongoing process of impact monitoring; it could not be just done one year and then not looked at for another 10. It needed to be a continuous process of monitoring across all the different dossiers.

Improving data availability at the EU and global levels

An official emphasised that there were many gaps in the data needed to monitor securities financing markets. This was true in repo markets in the US in particular in the bilateral market. In securities-lending activity, there was some aggregate information, but there was a need for more granular and detailed information in order to understand what was going on in the markets.

To close these gaps in the US, the OFR, in collaboration with the Federal Reserve and the Securities and Exchange Commission (SEC), was conducting two pilot data collections: one on the bilateral repo market, and the other on securities lending.

In the bilateral repo market, the results from the first collection – which had been done on a voluntary basis – had been published. This had been a sandbox-type activity, which had been completely voluntary. It was estimated that bilateral transactions accounted for around half of the US repo market. Using the lessons learned from that pilot, the OFR would move forward with a permanent collection for the benefit of regulators and market participants. One of the important points about the pilot was that, by engaging with industry from the start, they were able to understand exactly what the data represented and how best to collect it in order to get recommendations from the industry. Therefore the first point was to establish a partnership between regulators and the industry.

In the securities-lending pilot, they had collected a limited amount of data from a different set of firms; those active in markets on an agency basis. Some of those activities were still principal-based, but they had wanted to start with the agency part. This data was now being analysed, and hopefully there would be a permanent collection going forward.

There was a need to standardise the data that was used to represent and measure SFT activities. In the US the CFTC and the SEC had embraced the use of Legal Entity Identifiers (LEI) for identifying the parties to transactions, and hard work was needed to continue to develop the Unique Product and Transaction Identifiers (UPI and UTI) that would enable them to know precisely what data was collected, notably by trade repositories.

At the global level, the US was collaborating with its global counterparts. It was important to understand the differences across the markets and how they were interconnected. If a shock occurred in one part of the world, it was almost certain to be transmitted to another part of the world, and the transmission mechanim needed to be understood. This was being done in a variety of ways. It should be emphasised that the interests of regulators around the world needed to be aligned with those of market participants, in order for the job to be done right.

A central banker said that there was a need for more tools in Europe, as there was a particular challenge: securities financing data was spread out over multiple data warehouses and databases. At the Eurosystem level they had begun a project to consolidate those decentralised databases into one securities financing transaction database which would be used at the ECB level for the purposes of supervision and oversight. This would also be made available to bring transparency to the market, and hopefully there could be cooperation with the US in order to bring this information to the global level.

An official noted that in many markets, market participants could express a view in many different ways, such as cash, futures, options, etc, reflecting the same basic economic fundamentals but occurring in different areas of the financial system. When gathering information, particularly under stress, it was important to look across those market platforms and trade repositories, co-ordinate and make sure that those data were available to both market participants and regulators.

Liquidity data

An asset manager stressed that numbers alone did not give the whole picture. For example, larger sized transactions had given the appearance of continued liquidity, but it did not necessarily mean that. Liquidity really depended on how many market-makers were making a price and whether those prices were in line with what the real market should be or whether people were being forced to execute short-term transactions at an unjustified price because they had no alternative.

Another industry representative pointed out that, while market and credit risk measures were often supported in markets by dozens of years of data, liquidity as a measure had less data support when regulatory regimes were looked at, for example liquidity measures in terms of assumptions about the depth of markets and over what periods a portfolio might be able to be liquidated. It was a constraining issue for firms, so reaching parity in terms of data and measures was more important in liquidity than in other areas.

An industry speaker emphasised that, from a risk management perspective, primary risks were often easy to measure and manage, such as exposure to equity or debt markets. One of the things that the repo market could help mitigate was the effect of what would be called ‘basis risks’. These were pernicious because they were not easily seen, measured or modelled. When liquidity was discussed, it could be discussed in its primary sense, but there was a secondary impact as well in terms of what it said about basis risks, which was a further reason to want to manage it well.

A public representative noted that there was a need to find a way to work cross-border, and to establish models for measuring liquidity depth and breadth, as it was unclear that anyone understood what liquidity was. This would mean something different to each participant, and a way was needed to at least measure what was meant by liquidity depth and whether or not it was really important for good functioning of markets. It was important to start understanding the impact of different factors. ESMA would have a difficult job assessing the impact of pre-trade transparency on the fixed-income markets in particular.

Conclusion

The chair summarised that the key points to take away were that the market situation was not alarming but worrying, with some activities shrinking and difficulties around pricing risk. The picture was not only bleak, but uncertain. There was not sufficient understanding of these markets because the data to understand what was happening was not completely available. Positive developments were taking place in the US and the EU in that respect, but it would be important to be able to assess those markets and the data coming in at the global level. Until that was possible, there was a strong call for caution, for a regulatory pause and for developing a better understanding of what had been adopted and enacted until now, bearing in mind that sometimes regulation could be positive and allow markets to function better.

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1 The Tri-party Repo Infrastructure Reform published in 2012 aims at (1) sharply reducing the market’s reliance on discretionary extensions of intraday credit by the clearing banks and (2) fostering improvements in market participants’ liquidity and credit risk management practices