FIXED INCOME ACADEMY

Special Report | Repo Market Update

- **Written for:** Bond School Students, Grads and Interested Parties
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Ronald Mark, MBA, is a former Director and Senior Trader of Fixed Income Trading for BMO Capital Markets. With over 30 years trading experience, both domestically and internationally, Ron has extensive knowledge and experience in the fixed income markets, particularly the front end of the U.S. Treasury market. Ron produced consistent profits for several Primary Dealers after graduating from the UCLA Anderson School of Business in 1982. Mr. Mark is now a consultant to investment managers, and publishes his easy to comprehend and timely updates on the bond market in his “Interest Rate Specialist” blog (link to http://interestrates-us.com). You can connect with Ron on LinkedIn (http://linkedin.in/in/ronaldmark).

What You'll Learn

While repurchase agreements are seemingly simple, they become complex very quickly in this jargon-laden world as one transaction is quickly layered on the next. Several regulatory bodies, such as the Federal Reserve, SEC, CFTC and BASEL, are evaluating a myriad of proposals as we continue to work through the implementation of Dodd-Frank. The end goal is to reduce systemic risk by minimizing the use of "shadow-banking", which is estimated to be as high as *$60 Trillion* worldwide.

But what exactly is "shadow-banking" and what is really happening with regulation? We were fortunate to be able to ask market experts these questions and pleased to be able to pass along a recap for readers interested in the topic. We've also included some basic definition of terms, seeing this as a perfect opportunity for a *Back 2 Basics* moment.

This report is a summary of a recent Bond School Conference Call. (Replay)

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Susan Munson, Founder & CEO, Fixed Income Academy

Regulatory Changes and Their Impact to the Repo Markets
by Jeff Kidwell

DODD-FRANK IMPLEMENTATION AND RULE 165- the Dodd-Frank Act, Rule 165, Rule 984, the Collins Amendment are impacting securities lending agents' and their beneficial owners' risk management and ability to do lending and repo with certain large SIFIs (Systemically Important Financial Institutions). The entire Dodd-Frank Act has 16 distinct titles. The almost 300 distinct rules are still being proposed and debated, three years after becoming law, with only 104 so far finalized. The rules not only impact the broker/dealers and the banks, but also effect some non-US financial institutions and many investment managers. There are titles of the Dodd-Frank Act that cover several reforms including: shadow banking, tri-party repo, money market funds, supplementary leverage ratios, CCP/SEF Rules for derivatives, Volcker Rule, and several overlaps with Basel

III. The takeaways from the discussion are that this is a multi-faceted approach by multiple agencies and regulators, which will have a dramatic impact on the repo & securities lending market. All of these "reforms" could limit the ability of firms to trade with each other, increase the costs and capital needed to trade repo, and increase the costs of reporting and monitoring risks.

FSB/FSOC SHADOW BANKING REFORM AND DISINTERMEDIATION- the reform is intended to reduce systemic risk, increase financial stability, and to get at just exactly what repos are out there (transparency of repo data), as most of the estimated $60 trillion in shadow banking is hard to determine from what is actually reported on banks' balance sheets. It is not easy to see that a broker/dealer reversed in collateral from another broker/dealer who may have reversed it in from another broker/dealer and the security may have been repoed six or seven times since it was first reversed in from an end-user collateral provider. There is no actual limit on the number of times that one security can be repoed. The multiple uses of a single security for trades in the repo market currently don't get captured but do represent potential systemic risk. This can have a large impact of liquidation on multiple rehypothecated securities for firms within that daisy chain. The focus of the FSB appears to be leading to an overall disintermediation of intermediaries such as the broker/dealers. The Shadow Banking Reform also shines a spotlight on money market funds and their susceptibility to "runs", leading to some of the money market fund reform work, which could be viewed as some more disintermediation. I think it's interesting how many of the topics are interrelated and the regulatory push, although from many different regulators, appears to be coordinating along several different points of engagement. The regulators have proposed establishing numerical minimum haircut floors as a way to reduce leverage (something Fed's Stein recently spoke about).

TRI-PARTY REPO REFORM-As mandated in Dodd-Frank, the Federal Reserve is intent on the risks it perceives in the $1.8 trillion US Tri-Party Repo market, particularly after notable events in the financial crisis. They have made moves to reduce systemic risk at the custodian bank level through different cutoff times (releasing the cash later) and moving the risk back to the cash providers and collateral providers and away from the clearing banks, through intraday credit extension and caps. Money market funds currently make up 30-40% of the Tri-Party repo market. Having accomplished much of the needed reduction in the market's usage of clearing bank intraday credit, the Fed is now shifting its focus to the remaining policy concern, namely the risk of 'fire sales' of assets in times of stress. The Fed has recently highlighted the systemic dangers associated with 'fire sales' and suggested that if the industry didn't come up with a solution, the Fed could act to put additional restrictions on repo activity for entities that are part of a bank holding company and come up with its own solutions. There are several proposals on the table from the industry and from the Fed, and I go through them on this call and will tackle them in even more depth at the GIOA conference in March. (Replay of the GIOA conference call)

BASEL III: LCR, HIGH QUALITY COLLATERAL, BALANCE SHEET AND HAIRCUT IMPLICATIONS-The Basel Committee has been redefining what constitutes bank capital, the Liquidity Coverage Ratio (LCR), and the two new capital buffers for capital conservation and the countercyclical buffer and an additional buffer for Systemically Important Financial Institutions (SIFIs). The market still has concerns that this will cause trading repo, particularly for broker/dealers, banks, and SIFIs, to probably become far more expensive, will push those participants to do longer-term repos to show long-term liquidity (which is counter to the money market fund reform objective for cash providers below of shortening repo maturities), may push bid/offer spreads wider, and may (in an unintended consequence) push banks to move their balance sheet for repo into higher bid/offer spread and less-liquid collateral types to generate similar returns to what they make now. There is also concern about the coordination with efforts by other regulators and how the rules will be implemented in different jurisdictions.

FED/FDIC PROPOSED LEVERAGE CAPS-These two regulators have recently proposed a 5-6% capital buffer for U.S. G-SIBS, in addition to Basel III, which would make repo trading even more expensive for those participants and would likely be passed down to end-user customers in the form of wider bid/offer spreads and further deleveraging.

SECLENDING PROGRAM INDEMNIFICATION AND SPLITS-The new Dodd-Frank and Basel III rules will cause securities lending agents to take hard looks at the indemnification they may offer to some beneficial owners and price splits accordingly, if they offer that indemnification at all. Historically, indemnification capital costs and value were generally in line and thus indemnification was not explicitly priced. The potential increase in capital cost could lead to a more explicit pricing of the feature.

CCPS (Central Counterparty Clearing) AND COLLATERAL OPTIMIZATION/TRANSFORMATION-The new accounting rules, to be implemented on the 168 countries in 2019, is not consistent across all jurisdictions, particularly in regards to bankruptcy rules and novations. It is still not yet a risk-based capital standard. It is expected to cause participants to engage in major balance sheet optimization, the first wave of which the audience is seeing in terms of broker-dealer reduction or rationing of balance sheets. The second wave is expected to involve the broker/dealers (and other derivatives users such as insurance companies) transforming their collateral into Tier 1 assets for Basel III and Tier 1 assets for initial margin posting at CCPs for derivatives trading. I haven't seen much of that collateral upgrade trade happening yet, despite the many articles out there and heavy marketing by prime brokers, vendors, and clearing banks.

FSOC MONEY MARKET FUND REFORM-The basic parts of the reform (although proposed somewhat differently at the SEC, FSB, and Federal Reserve) include 1) better disclosure of exposures, 2) the SEC proposals that include floating NAV, redemption gates, and additional capital buffers, and 3) the FSOC's follow-up on those proposals, which included capital on the minimum balance at risk and the elimination of amortized cost for short-term investments. The potential negative impact on some money market funds has led to the move by some money funds to create Cash Management Accounts or Separately Managed Accounts, which are set up for individual institutional customers, the majority of which still adhere to 2a7 rules and are mostly rated, but may not be under the purview of Money Market Fund reform. Some people have also estimated a potential decline to the Prime Funds' space of about 50-75%, which might cause problems for reinvestment by seclending agents and beneficial owners.

FEDERAL RESERVE'S REVERSE REPO FACILITY AND NON-TRADITIONAL REPO COUNTERPARTIES-The Federal Reserve, as part of their new Reverse Repo Facility, expanded their list of cash provider counterparties to 139 counterparties in addition to the now 22 primary dealers. Some have viewed this as another disintermediation of the primary dealers. Others have viewed it as a new liquidity tool and a monetary policy tool that could enable the Federal Reserve to peg repo rates, in addition to IOER and Fed Funds target. There has been a similar move by many cash providers and collateral providers to find non-broker/dealer repo providers, particularly money funds with rated insurance companies and rated banks, and seclending agents' beneficial owners with rated and unrated collateral providers like REITs. Although this involves some education of clients and some new counterparty credit and documentation work, the benefits of accessing product (which is now severely limited at traditional broker/dealers who are shrinking balance sheets), achieving counterparty credit risk diversification, while obtaining higher yields and higher haircut protection, have sparked people to get involved. The subject of non-traditional counterparties, as well as non-traditional collateral, to achieve significant yield pickup, has been a major topic of the market lately.

FINANCIAL TRANSACTION TAX (FTT) PROPOSAL-many market participants believe that, in general, this tax to financial transactions (and recently mentioned by Fed's Stein specifically as a tax for 'securities financing transactions') will increase the cost of doing repo business, likely widening bid/offer spread, as the cost is either passed on to end-user clients (cash providers and collateral providers) or is priced to eliminate some of the business. It is currently being most actively discussed in 11 European jurisdictions, especially France and Germany.

LATEST ON THE VOLCKER RULE-Basically, this section of Dodd-Frank Act narrowly defines proprietary trading (to distinguish it from 'hedging') and prohibit deposit-taking institutions from taking risk in proprietary trading, to reduce overall systemic risk. Although regulators voted to approve the rule at the end of the year, they think the market may need a delay in implementation, in order to be compliant. They are also mulling over whether there needs to be changes for CLO trading. The bottom line for some beneficial owners and the US Treasury is that the rule, as it reduces proprietary trading in two major sectors on several different products, may remove some of the natural 'short-selling' in the market, which would reduce the amount of securities borrowed from seclending operations by both sectors and could reduce the liquidity of outright auctions (for instance, for US Treasury securities).

Repo Related Glossary
by Ronald Mark

Tri-party Repo: Tri-Party Repo is a kind of repo where an intermediary, typically a custodian bank, facilitates the exchange and monitoring of money and collateral. A tri-party intermediary also extends credit in its role as a full-fledged counterparty in the trade.

Re-hypothecation: In the repurchase market parlance this is called a security being "repoed". It is the practice of banks and brokers using, for their own purposes, assets that have been deposited in one of the firm's accounts. It is usually done with collateral from, but not limited to, segregated accounts. Collateral may also be "repoed" from the firm's co-mingled accounts. Regardless of what type of account it comes from, there is no limit on the number of times the same piece of collateral can be used in the chain of repos between intermediaries.

Shadow Banking: Transactions that are not captured on the balance sheet because of their structure or use in other offsetting trade.

Tri-Party Clearing Banks: Two money center banks have 95% of the market share of tri-party repo. Bank of New York-Mellon clears 80% and JPM Chase 15% of all tri-party repo trades.

Fire Sale: A cash provider involved in a rapid sale of collateral due to the default or deterioration of the financial condition of the borrower. If more than one seller is holding similar collateral the sudden sale by multiple participants of a large amount of similar securities may unnecessarily stress the market.

Tri-Party Repo Reform: A set of Federal Reserve proposals to strengthen the resiliency of the repo market. The reforms include: reducing intraday credit risk, improving the systems and controls used by all repo market participants, focusing on the risk monitoring practices of broker/dealers and reducing fire sale liquidation whenever possible. These reforms, aimed at the investment, trading and clearing of repo will reduce the systematic risk inherent in the movement of collateral between numerous counterparties.

Basel III: A global regulatory standard to improve risk accounting for all entities that do securities trading. Key Principles include: limiting leverage, stiffer capital requirements, balance sheet restrictions, liquidity stress tests, and universal collateral haircuts.

Delivery Versus Payment (DVP): A repo settlement procedure requiring borrowers to pay for securities at the time of delivery. Also called bi-lateral repo, as opposed to tri-party repo.

Supplemental Leverage Capital Ratios: A provision by major bank regulators that would require the biggest federally insured banks (SIFIs) to hold 5% of their total assets at the bank level, and 6% at the holding company level in capital as part of their mandated leverage ratios. These are a supplement to the capital ratios in The Dodd-Frank and Basel III reforms.

Dodd-Frank Rule 165: A feature of the reform that limits what any one customer can do with their bank. Single counterparty credit exposure to any unaffiliated party will be limited set to a percentage of capital not to exceed 25%.