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The Case for Peer-to-Peer Repo Solutions in EMEA

By Cassie Jones and Travis Whitmore

How can unlocking new sources of liquidity and collateral help alleviate financing needs during times of crises?

A changing market environment has produced refreshed urgency to establish the right tools for liquidity and diversification. Uncertainty is prevalent as global markets are debating a near-term recession, while a recent (albeit contained), banking crisis is top of mind for investors.

Volatility and credit concerns emphasizes the need for risk-efficient options for cash investment and cash borrowing. Additionally, there is a significant opportunity cost associated with excess cash with interest rates well into positive, restrictive territory across many locations around the globe. The interplay of these considerations builds the case for alternative repo solutions. Repos and reverse repos - or repurchase and reverse repurchase transactions - provide essential market infrastructure to provide short term collateralized loans to market participants. Many investors are turning to the secured markets as a way to place their cash, which provides the safety of collateralization, rather than remaining unsecured. Conversely, repo acts as an efficient way to source cash for various funding requirements. As a result, investors are evaluating alternative repo solutions to diversify their collateral sourcing and cash investment capabilities, which can be critical during times of crises.

In this article, we review the evolution of the repo market, describe the effects of recent market events and outline how a peer-to-peer repo model can be beneficial in Europe, Middle East and Africa (EMEA) markets.

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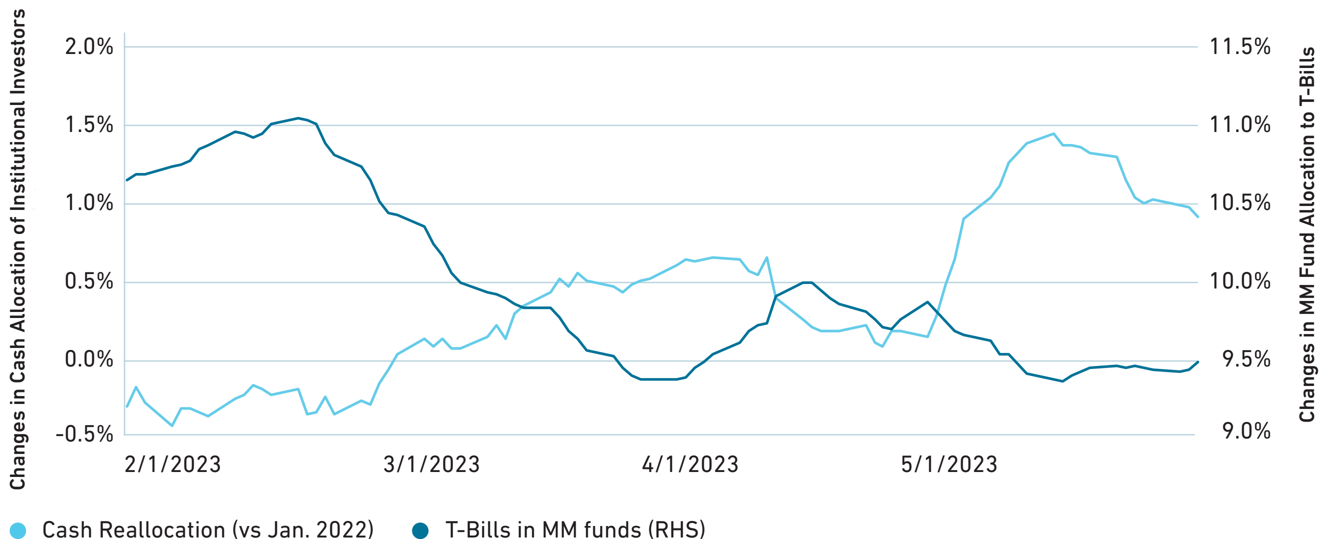
Review of developments in alternative repo solutions – FICC Sponsored Member Repo

As an aftermath of the Global Financial Crisis, additional regulations with capital requirements such as Risk Weighted Assets (RWA) have reduced the appetite for traditional on-balance sheet lending that banks previously offered in abundance.

In lockstep with the buy-side's evolving needs, a mainstay of cleared transactions re-emerged – FICC's Sponsored Member Repo programme[1]. In addition to Fixed Income Clearing Corporation's (FICC) credit rating, the cleared structure mitigated capacity constraints over month, quarter and year-ends. This programme has evolved into its own segment in the repo markets. As it effectively met market needs, this program continues to be a significant repo and reverse repo counterpart to money market funds, asset managers, pension funds and hedge funds. Non-US firms continue to make up a growing component of the FICC Sponsored Repo market with 17 jurisdictions approved. The important role that FICC's cleared structure plays in meeting financing needs of institutional investors is more evident today. Recently, we have observed a flight to safety of global institutional investors (shown as the reallocation to cash in Figure 1). The below shows a clear reallocation into cash from institutional investors and a shift out of T-Bills of MM funds YTD. This information represents institutional investor positioning from aggregated and anonymized holdings across stocks, bonds and cash.

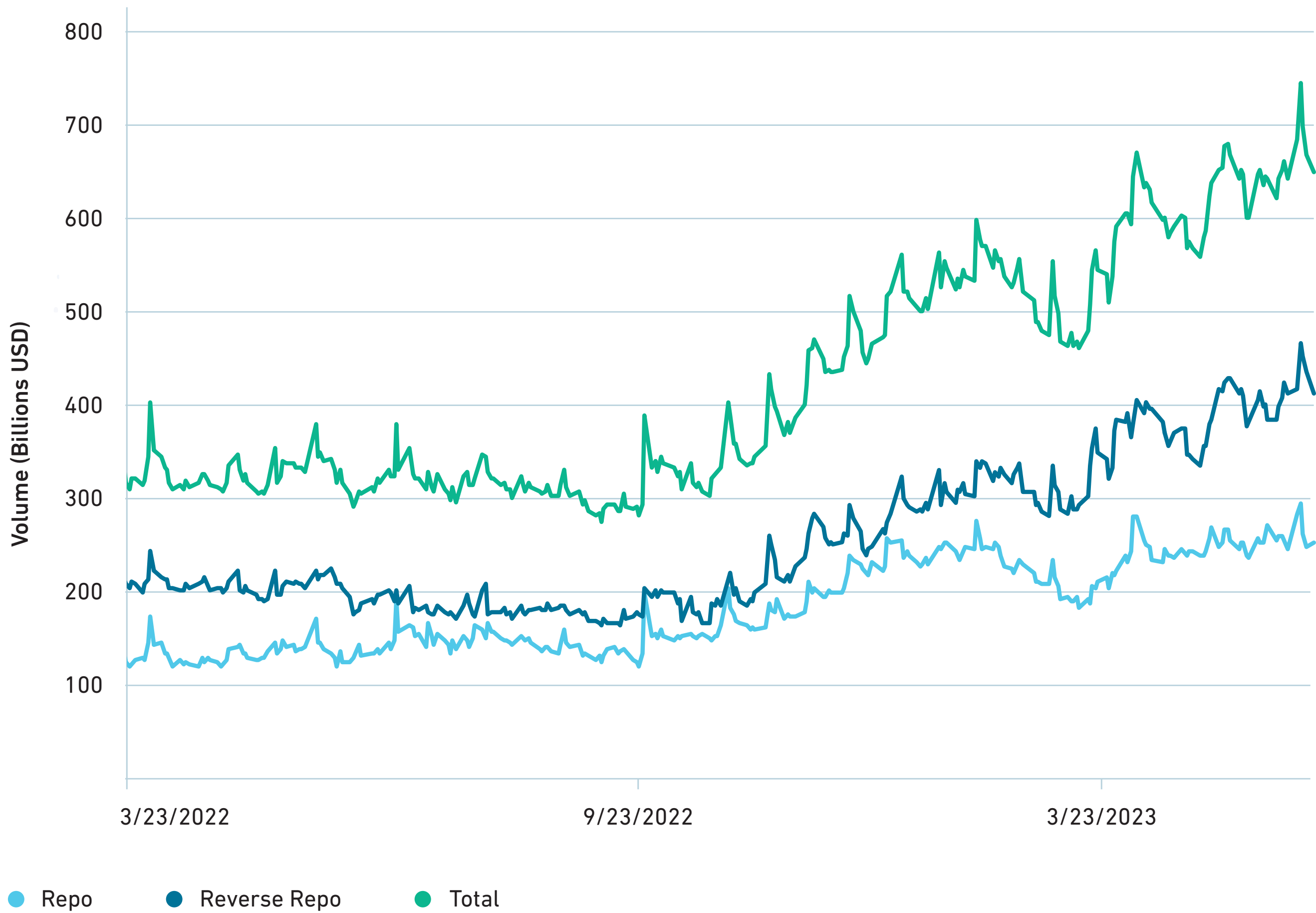
Figure 1: Asset Allocation of Institutional Investors and Money Market Funds (vs. January 2022)



Source: State Street Global Markets. As of June, 2023

As a result, the FICC Sponsored Member Repo program has witnessed a surge of over US$750 billion in daily volume, surpassing the COVID-19 highs (See Figure 2). Amid stable balances of around US$2 trillion in the Fed's Reverse Repo Programme (RRP), money market funds are still investing near all-time highs in the FICC repo program to earn additional investment income on cash holdings. As a result, there is still a significant amount of liquid cash available in the market.

Figure 2: Money Market Fund Sponsored Repos in FICC Balances (Weekly Average USD Billions)



Source: FICC Sponsored Member Repo. As of July, 2023

Recent market events demonstrate importance of diversified financing tools

Over the last several years, we have observed how monetary policy can cause shocks and structural dislocations in cash liquidity and collateral availability.

Market participants can recall the pressures that emerged in past years with quantitative tightening, with repo rates hitting an overnight high of around 10 percent in September 2019, as shown in Figure 3. Events like these are often driven by a confluence of factors that can contribute to cash scarcity, such as deadlines for corporate taxes and issuance of new treasuries, which is exacerbated by declining levels of reserves in the banking system.[2] More recently, as the Fed has increased interest rates to combat higher inflation, we have seen repo rates also increase with the Fed RRP acting as a floor and the Standing Repo Facility (SRF), implemented in July 2021, acting as a cap on rates (albeit an untested cap).

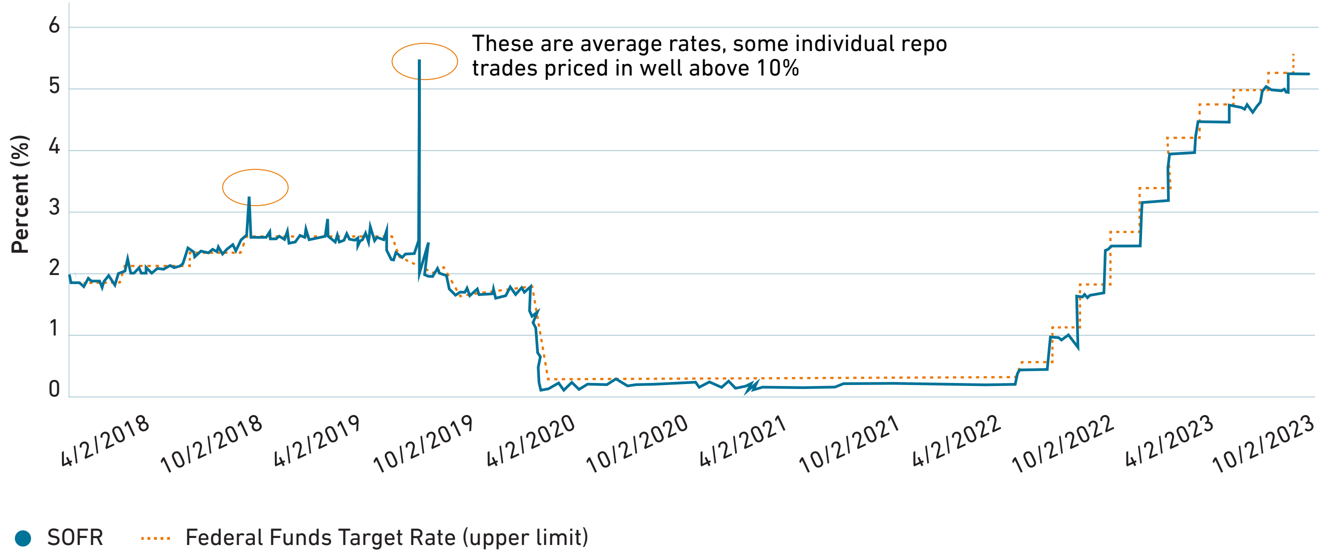
In Europe and the UK, the sponsored repo models have yet to become a staple in the markets to help alleviate funding strains. More recently, the UK Gilt crisis in September 2022 highlighted the need for a diversified set of tools to quickly source high-quality collateral. An unprecedented increase of 1.6 percent in 30-year UK Gilt yields (with daily movements of 10-20 standard deviations), placed enormous pressure on UK Defined Benefit (DB) pensions to generate collateral for interest rate swaps and FX forward positions.[3] In an effort to quickly cover margin calls and without access to alternative collateral liquidity, funds had to liquidate some of their holdings.

Should we expect to see a revival of repo volatility? Based on our daily measure of inflation, called PriceStats*, we find that inflation has come off its recent highs, but it is proving to be stubborn and remains too high for most central banks, as shown in Figure 4. If inflation remains sticky, we are likely to see monetary policy continue to tighten, or hold higher as in the United States, increasing the potential for more volatility in the repo markets.

1.6%

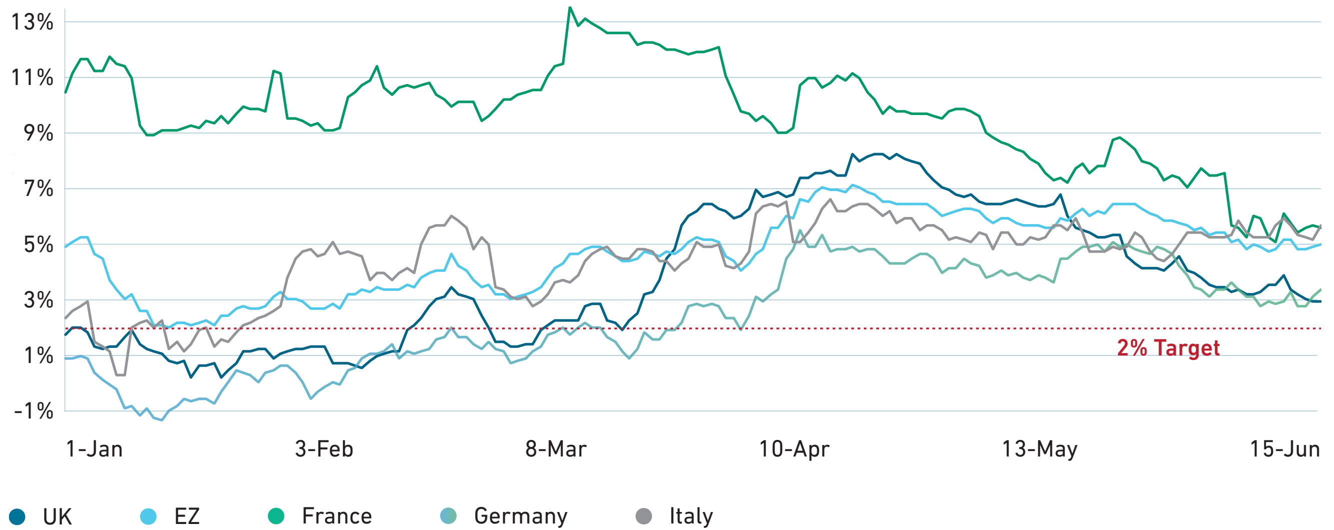
An unprecedented increase in 30-year UK Gilt yields placed enormous pressure on UK Defined Benefit (DB) pensions.

Figure 3: Secured Overnight Financing Rate (SOFR) and Fed Funds Target Rate



Source: New York Fed and FRED. From April 2018 - June 2023

Figure 4: PriceStats Inflation Measures for Eurozone



Source: State Street Global Markets Research, PriceStats

*PriceStats scrapes millions of prices from online retailers to generate a daily measure of CPI and PPP across 24 developed and emerging market countries.

Does the market need additional repo solutions?

The market dynamics described above certainly set the stage for peer-to-peer repo offerings to fit a market need globally. However, the case is strongest in EMEA, where several factors contribute to the need for alternative repo solutions.

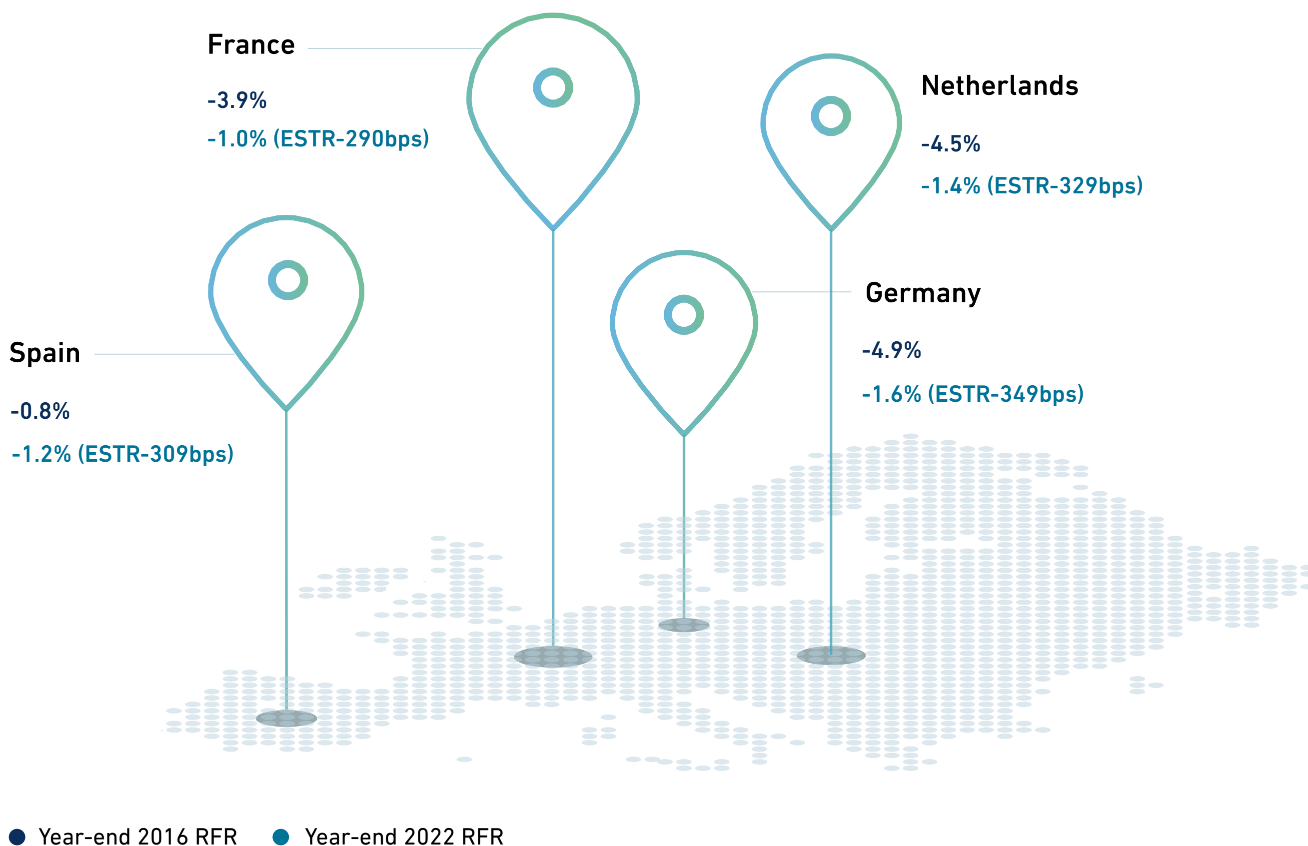
Access to liquidity is bifurcated across multiple jurisdictions and access to the European Central Bank (ECB) can be limited. Unlike the US, where a unified body sets and implements monetary policy, the Eurozone has a decentralized structure – national central banks are responsible for asset purchases and lending, not the ECB (with some program exceptions). In practice, this means investors establish differing criteria for a given country, resulting in fragmented General Collateral (GC) markets across Eurozone countries.

There are also structural features of Eurozone's financial market that makes a peer-to-peer repo model appealing, specifically, the historical dislocation between high-quality assets and excess liquidity. This so called "scarcity effect" is largely a result of the ECB's Quantitative Easing (QE) programs. In fact, the Public Sector Purchase Program (PSPP) was estimated to have reduced repo rates by 0.78 basis points (bps) for every 1 percent increase in outstanding bonds purchased.[4] As a result, we witnessed frequent high-collateral scarcities in European markets. We can recall year-end 2016, when collateral scarcity caused repo rates to plunge for high-quality liquid assets (as low as -9 percent). We continue to observe spikes in sovereign repo rates, with some GC spreads widening as much as 400 bps over year-end of 2022, as shown in Figure 5.[5]

Although the ECB's balance sheet has started winding down, these cases highlight the potential for peer-to-peer adoption driven by need for collateral. Peer-to-peer creates an additional opportunity for market participants to access balance sheets and assets that were traditionally off limits. For example, a hedge fund may be able to source specials from a large asset owner, sovereign wealth fund or insurer directly, and those asset owners feel comfortable trading with that hedge fund when there is a guaranty of the hedge fund's performance provided by the peer-to-peer program provider. On the cash investment side in EMEA, there is differential access to cash investment outlets for the US and non-US money market funds. The US funds are able to park cash at the Federal Reserve's Reverse Repo facility at stable rates. UCITS funds do not have access to the same Fed facilities. Likewise, a lack of significant balances in European Sponsored Repo programs limit the diversified and securitized cash options. Peer-to-peer repo could offer additional outlets for cash investment with more competitive rates as cash continues to be in abundance.

While the concept has been tested before – in 2015 a small group of insurance and endowments established "direct repo" trades to offer more flexible terms and pricing advantages to both sides[6] – the execution model has been significantly improved.

Figure 5: Weighted Average Year-end Repo Fund Rates (RFR) and Spread against Euro Short-Term Rate (ESTR) Over the Turn



Source: CME Group, European Central Bank, ICMA. ESTR for year-end 2022 was +1.89 % for the turn.

1. FICC Sponsored Repo https://www.statestreet.com/us/en/alternative-asset-manager/solutions/ficc-sponsored-member-repo
2. R Jay Kahn et al."Anatomy of the Repo Rate Spikes in September 2019." Office of Financial Research Working Paper. (2023).
3. "Bank of England Financial Stability Report." Issue No. 44. (2018).
4. William Arrata et al.. "The Scarcity Effect of Quantitative Easing on Repo Rates: Evidence from the Euro Area." IMF Working Papers. (2018).
5. Andy Hill. "The European repo market at 2022 year-end." ICMA Repo Briefing Note. (2023)
6. Viktoria Baklanova, Isaac Kuznits and Trevor Tatum. "Primer: Money Market Funds and the Repo Market. SEC Public Paper." (2021)

Our solution offers clients benefits such as

Program Guaranty

We provide a guaranty of the payment of the Repurchase Price to the cash lender, inclusive of proceeds from liquidating the repo securities. S&P and Fitch have reviewed the terms of the guaranty, affirming that the guaranty meets their principles for credit substitution of an unrated counterparty.

Streamlined Documentation

Rather than signing bespoke documentation on a per counterparty basis, we have created a streamlined set of documentation. Once executed, the documentation facilitates counterparties to trade freely between participants.

Competitive Economics

In a rising and competitive rate environment, the peer-to-peer structure may facilitate yield enhancement for cash investors and provide favourable financing for cash borrowers. In avoiding bank's balance sheets, we anticipate that lenders will receive a premium compared to dealer-offered repo rates.

Workflow Automation

In an effort to bring liquidity sources together, generate critical mass and automate the trade workflow, we partnered with FinOptSys to create an electronic peer-to-peer marketplace – Venturi℠. This platform allows counterparties to pool their liquidity and automate the full trade lifecycle. Further we offer an administrative function, providing daily margin requirements and reporting on outstanding guaranteed transactions.

Conclusion

Although peer constructs have continued to grow in fits and starts across EMEA, we aim to build a solution that addresses viability concerns. The collation of a guaranty, a centralized trade negotiation platform, triparty collateral management and streamlined documentation may allow European market participants access to their buyside counterparts directly, at better rates. In anticipation of market stress, it is essential to have a diversified set of cash investment and cash borrowing options. With our peer-to-peer repo solution, backed by our deep market expertise and extensive client network, we aim to revolutionize the traditional methods of repo trading and empower the buyside.

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