STOXX

Benchmarking European repo markets

The International Capital Market Association task force on repo indexes is evaluating new benchmarks for European repo markets. In a roundtable forum convened by *Risk* and sponsored by *Stoxx*, a panel of experts discusses the evolution and development of repo benchmarking in the era of central clearing

The European repo markets have an outstanding size of €5.5 trillion, and local securities markets such as Italy have grown rapidly in recent years. Collateral is being effectively reused for repo transactions that help asset managers make their assets under management work harder, which also enables bank risk managers and treasury managers to do their jobs more effectively.

Perhaps the single most important change in the repo market recently has been central clearing. Throughout the financial crisis, credit risk has been at the forefront of concerns for lenders, and central clearing has become a regulatory imperative.

Central clearing of fixed-income securities also facilitates the calculation of secured market indexes, such as the Stoxx GC Pooling Index Family, which in turn underpin a liquid secured market for secured funding in euros and US dollars dating back to 2005.

THE PANEL (left to right)

Konrad Sippel, head of business development, Stoxx
Yuliyan Georgiev, senior product development manager, Stoxx
Romain Dumas, International Capital Market Association, European Repo Council, Task Force on Repo Indices

Risk: What are the objectives of the International Capital Market Association's (ICMA) European Repo Council's task force working towards, and what conclusions has it reached so far?

Romain Dumas, International Capital Market Association, European Repo Council: The repo markets are big markets. They were big before 2008 but, in the following funding crisis, they have gained visibility. In Europe, repo markets have been able to counteract the reduction in unsecured lending and borrowing since the crisis. They are therefore mitigating the extent of European Central Bank intervention, and are facilitating liquidity. At an ICMA presentation in June 2013, Francesco Papadia – chairman of the board of Prime Collateralised Securities – highlighted a reduction in turnover in the unsecured interbank market of €327 billion compared with an increase in the turnover in the repo market of €212 billion. So, about two-thirds of that unsecured turnover reduction was picked up by an increase in the turnover of secured markets.

Looking at such large funding markets, for instance, you see that benchmarks such as the Euro Overnight Index Average (Eonia) are based on actual transactions – in Eonia's case totalling up to €20 billion. Meanwhile, looking at the secured market, we could see transactions conducted through central counterparties (CCPs), and such transactions could increase volume by more than €200 billion.

As an industry, we have a duty to determine whether there is interesting information we can extract from the secured market to increase transparency, enhance visibility for regulators, help market participants manage risk and monitor the monetary policy transmission mechanism. As repo professionals, we highlight that repo is the first link in the repo monetary transmission mechanism. This is not an original idea – such types of indexes do exist in the US. The Depositary Trust and Clearing Corporation's GCF Repo Index, for example, was created at the instigation of the Treasury Markets Practice Group, sponsored by the Federal Reserve, with a view to enhancing transparency in the repo markets.

Risk: Does the ICMA task force aim to promote similar indexes in Europe to those that already exist in the US?

Romain Dumas: The role of this task force is to imagine what such an index could look like in Europe. We have this wealth of data from actual funding transactions happening daily, and we are looking at whether it is possible to reproduce what is happening in the US. We need to take into account the difficulties in the eurozone, in dealing with a heterogeneous market – the liquidity is around national general collateral lines: Italian general collateral; French general collateral; and certain basket products, such as GC Pooling. The CCPs are subject to sovereign risk and wrong-way risk, which you do not have in the US. And Europe does not have a pure general collateral finance (GCF) product such as that in the US. These are the challenges we have identified. Nevertheless, we think it is worth trying to overcome these obstacles.

Risk: Can you tell us how repo markets promote better risk management for banks?

Romain Dumas: We have seen the importance the repo funding market has assumed during the global financial crisis. As banks moved to collateral-adjusted valuation, we realised that the models being used could not distinguish between cash – euro cash at the Eonia rate, for example – and margining taking place in securities. That is, most of the time you use the same curve, whether the margining takes place in Italian government bonds, cash, German government bonds or another basket of eligible bonds. And we know that the funding implications of these various instruments are not the same.

Risk: What does the task force plan to work on next?

Romain Dumas: We've come up with principles that we think a repo index should follow in order to be satisfactory for the ICMA's European Repo Council. Obviously, stakeholders may think these principles are not enough, or they want to make additions. But they are the minimum principles that we feel should guide the market.

Ideally, we would like to have an overnight term fixing because, in reality, the market is in overnight transactions for the repo market – that is why such huge volumes exist. So we're now focusing on that and calling on existing liquid markets, which are along national general collateral lines with certain baskets. We're capturing only centrally cleared transactions – we want a broad base, and we want to capture that large volume of transactions. This can be difficult because, with general collateral, you do not have a pure GCF. You have a true general collateral basket product, and you have a lot of bonds that trade general collateral but not in a basket. And that should be governed by an industry body.

Risk: Stoxx has developed the GC Pooling family of indexes for the secured financing markets. Why is Stoxx active in this area of benchmarking?

Konrad Sippel, Stoxx: This presents a golden opportunity for us. There is clearly a need for benchmarks in the secured space. And there has been a gigantic market movement towards this area. We very much welcome the criteria set by the ICMA, and we believe these are criteria that make a good index. We are an independent and rules-based index provider; we create indexes in markets where we can do that, and where we can use actual market transactions or regulated market prices to create solid rules-based and transparent benchmarks.

With the GC Pooling platform that has developed over recent years and has significantly picked up volumes, we now have a resource from which we can source these prices, where the transactions are centrally cleared and independently regulated. This gives us a very solid basis for creating a good and transparent benchmark that, in our view, ticks a lot of the boxes that Romain has mentioned.

"We believe that this market, especially given the liquidity on exchange and on platforms, is going to expand beyond the overnight"
Konrad Sippel, Stoxx

Risk: The European repo market is large, but it hasn't grown substantially in recent years, as banks' capital bases are constrained by regulatory change and tough markets. Looking ahead, where do you see the potential for the repo market?

Konrad Sippel: I'm not very good at 'crystal-ball predictions' but, at Stoxx, we are measuring markets and creating benchmarks, and we'll see where things go. Obviously, we have aspirations. We believe that this market, especially given the liquidity on exchange and on platforms, is going to expand beyond the overnight. In the short term – in fact, we can already see this – it will move towards more standardised, long-term transaction trading. And we certainly hope that there will be an increase in volume.

Risk: Is the repo market going to become a more central feature of risk management?

Konrad Sippel: To some extent it has always been an important feature. But it is moving more towards regulated platforms and central clearing. This plays well in our cards, and I guess also in the ICMA's cards to some extent, because you have more reliability about the information and you simply have more information available. I do expect that particular trend to continue.

Risk: How are the Stoxx indexes constructed? What types of collateral are you dealing with, and what are some of the technical challenges you've faced in structuring the indexes?

Yuliyan Georgiev, Stoxx: Let me give you some key facts about the GC Pooling market, to provide an understanding of what is behind the indexes.

"If we want to build up the complete curve based on transactions, that is currently not realistic. So there are many constraints and issues we need to take into account in order to address and minimise any potential issues"
Yuliyan Georgiev, Stoxx

First, we have a very liquid electronic anonymous market, which was established in 2005 and has recorded double-digit growth since then. In 2013, it saw daily outstanding average volume of €153.8 billion, with a peak of €185.5 billion in June.

We have centrally cleared transactions on the GC Pooling market, and we have the reusability of the collateral. On GC Pooling, we have two baskets: the main basket and the extended basket. The main basket is covering about 7,500 eligible securities, and the extended one approximately 23,000 eligible securities. These are pan-European baskets that cover the broader eurozone countries within.

Konrad Sippel: It's a pretty international platform. It is based in Germany, but is actually a European platform with 113 participants from 14 countries.

Risk: What is going to influence the development of benchmarks in the future?
Romain Dumas: There has been a reduction in balance sheet across the Street, which has been affected by the outstanding amount of repo. Nevertheless, we don't think the importance of the secured funding market is going to diminish. The trend towards being centrally cleared is going to continue to represent by far the biggest portion of the market, even if it fluctuates, most notably for the most liquid products such as government bonds or the liquid baskets. Earlier I mentioned a turnover number of qualifying transactions according to the criteria. In calculating that number, we were only looking at the two biggest CCPs in terms of repo: LCH.Clearnet and Eurex. That shows you the depth of the volume. Even if it fluctuates, we think it is going to continue to represent a very significant volume. And all monetary policy is based around repo, so we definitely do not think it is going to go away.

Risk: We have seen the development of futures products based on repo indexes in the US. Could this happen in Europe also?
Romain Dumas: Why not – if the right product comes along, and is satisfactory both to the regulators and to market participants? If they feel that the underlying index, on top of meeting the regulatory criteria, also satisfies all the other criteria, then why not? At the moment, the difficulty is that we have very low rates, a very flat curve and not much volatility. The moment you start to have volatility, these kinds of instruments will gain traction.

Risk: Are market conditions going to provide the biggest boost to liquidity in these markets? Or do the regulators have a role to play?
Konrad Sippel: We take a slightly different point of consideration from the index provider's point of view, which is the use of these indexes or the secured benchmarks in everyday transactions. Today, even though secured funding has probably exceeded the unsecured funding in volume, you still see unsecured rates being used widely in structured products. Eonia and Libor are almost standard in a number of agreements. One of the bigger growth areas from an index point of view is the greater use of secured benchmarks in all those products. That process is going to take time, but it is also a key process that needs to happen before you can really talk about successful derivatives – such rates need to be used on a much broader basis.

We are going to focus most of our efforts on talking to the people who are using rates, and making the case for secured funding versus unsecured funding – introducing them to benchmarks that we consider helpful, and hoping for increased use. And, obviously, those rates are being used increasingly across a range of derivatives industries, so you should also see a boost for the underlying liquidity on the platform.

Yuliyan Georgiev: Our answer is an index that potentially covers all of these points, having been based on centrally cleared trades and potentially with more volume, as we see in Eonia. So, we launched the Stoxx GC Pooling Deferred Funding Rate, which has pretty much a stable trend towards Eonia and the unsecured market, due to the motivation behind it – it is about cash-driven funding.

Risk: Are there any technical challenges that you will need to address over the next year?
Yuliyan Georgiev: The current liquidity reality is the short term of the secured market. If we want to build up the complete curve based on transactions, that is currently not realistic. So there are many constraints and issues we need to take into account in order to address and minimise any potential issues.

Konrad Sippel: It is an ongoing process when you launch a product like this, specifically with a somewhat new asset class. At least, for us, it is a new asset class. You begin a market dialogue, such as the dialogue we have had with the European Repo Council at ICMA. You gain valuable feedback, and you begin to make minor improvements to the indexes. For example, based on feedback and in order to improve the quality of the information we provide, we have included a lower buffer for the size of quote that is being considered for the index, to avoid the possibility of a large number of small quotes influencing the index. We are learning.

As another example, market participants have asked for additional transparency around the number of quotes used in the longer-term indexes, and we are happy to provide that. It is a bit of a learning process, understanding what we need to do to build an acceptable benchmark. And we certainly welcome the feedback we have received from the ICMA.

Romain Dumas: There are several efforts under way to provide that feedback for all new market initiatives in this space. The various initiatives look at different segments of liquidity in the market. We will monitor how the market develops.

Konrad Sippel: It never works if an index provider sits in their ivory tower, comes up with some concept and thinks it is going to conquer the world. This is always something that requires interaction. And it is incredibly helpful that there is a group within the ICMA that provides a concentration of expertise. We can present our concepts and receive feedback, continue that dialogue, and continue improving our product. Of course, we're not the only offering out there, but we think we have a pretty strong product and we are working to improve it.

Risk: Are these repo benchmarks being used to create structured products in the institutional market rather than the retail market?
Konrad Sippel: I don't think I would even make that distinction between the two markets. Structured products, per se – regardless of their target audience – often carry some form of interest rate component, perhaps some sort margin over a market rate. And, typically, just because of historical standards, this will be calculated using unsecured rates. That has been the market standard, and it is always incredibly difficult to break through that to establish a new market standard. That is ultimately the challenge we have all faced before: to bring secured funding to the forefront and then establish a benchmark that everybody agrees on.

There is a large number of indexes out there, which creates confusion. It is important to have just one thing that is right out in front, which people can look at and say "this is the benchmark". We have established the Deferred Funding Rate for the Stoxx GC Pooling Index Family, which is, at least initially, designed to take exactly that role. And that could, of course, be used right away to replace some of the unsecured benchmarks in some of those products. But we are realistic, and understand this is a process that is going to take a lot of talking, a lot of convincing and a lot of time.

Risk: Central clearing is clearly a driver of change. Do you see opportunities to use the data CCPs provide to create new benchmarks?
Romain Dumas: Yes. Or, at least to look at creating an index benchmark. Our first ambition is to see what a repo index should look like – or what repo indexes would look like – as there could be several, sustainable repo indexes. This the only market where there is such a wealth of actual transactions, even if you focus strictly (which is one of our principles) on CCP transactions, and even if only on electronically transacted trades. Here you have two layers of governance: the control of, and the validity of, the trades.

Risk: What message would you like to get across to risk managers or banks that are looking to use the repo markets in these indexes?
Romain Dumas: We must recognise this is as a funding market in which you have large volumes of funding transactions that are centrally cleared. This suggests to us that we have the main ingredients to create an index that will be satisfactory to the regulator and to market participants.

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Romain Dumas, International Capital Market Association

Looking at the history of the futures market in Europe, the MATIF [Marché à Terme International de France] futures index covered French government bond futures and was possibly the most liquid index in Europe at one point. Then along came the Bund, Bobl and Schatz traded on Eurex, which gained a greater prominence in the market. But French futures did eventually make a comeback, in response to the needs of market participants. Similarly, we need to be guided by the needs of market participants today. The ICMA is here to help any initiative develop a product that will be satisfactory to the regulators, and regulatory approval will be the first condition market participants will need to see met if they are going to consider it.

Konrad Sippel: Ultimately, there are alternative benchmarks to unsecured benchmarks. And those alternatives are, in many cases, more applicable to what people are doing than the unsecured benchmarks they are using. We certainly believe the Stoxx GC Pooling Index family fulfils a lot of the requirements of the market, and that it will be very, very useful.

>> View the full proceedings of the *Risk*/Stoxx benchmarking forum, *Benchmarking European repo markets*, at *www.risk.net/2330746*