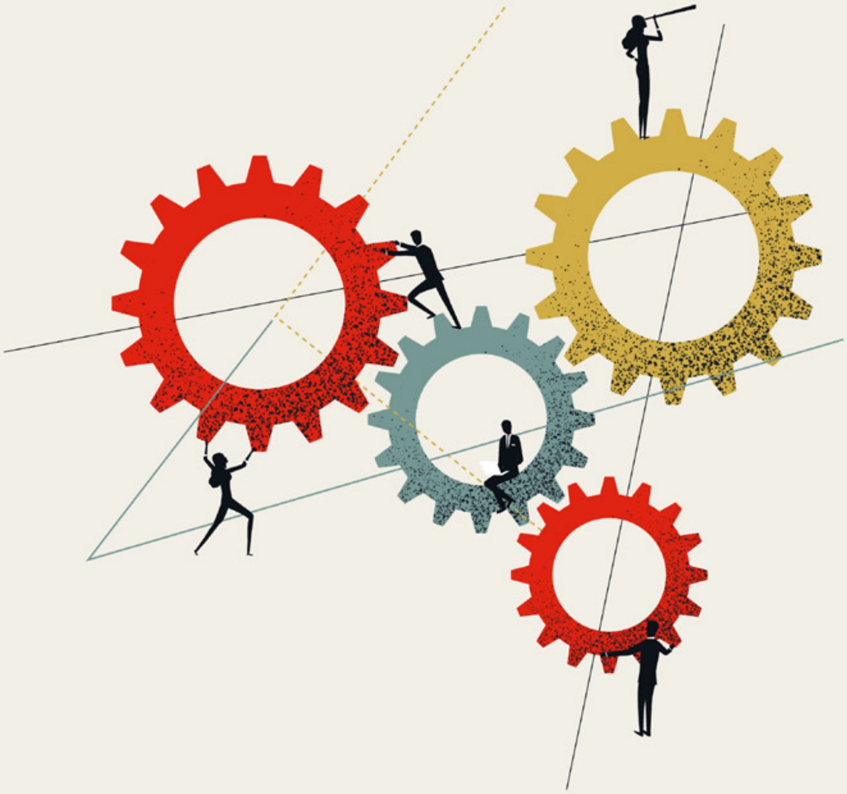

Securities finance in times of monetary transition

Clearstream's Marton Szigeti and Eurex Repo's Frank Gast speak to Bob Currie about how monetary readjustment, and changes in regulation and operational culture, are reshaping user engagement in securities lending and cleared repo markets

These are times of transition and readjustment for securities finance practitioners, driven by shifts in macroeconomic policy, geopolitical tensions, and by changes to the regulatory fabric overarching lending and financing strategy.

The European Central Bank (ECB) noted in its November 2023 statement that weaker growth in 2023, coupled with persistent inflationary pressures, underscores the importance of continued consistency between monetary and fiscal policy. While the ECB opted to keep interest rates unchanged at its 26 October meeting, it has repeatedly committed to setting interest rates "as high as needed for as long as necessary".

These factors are driving market participants to reassess their investment strategies, borrowing and lending dynamics, and risk management approaches within the industry. They do so against a background of significant financial uncertainty. It is widely accepted that we are nearing the peak of the tightening cycle — but opinion is split on when central banks will move to policy easing and how aggressively they will cut. This is reflected in wide dispersion in policy rate forecasts from market analysts and the signals on future interest rate pricing coming out of the forwards markets.

Higher for longer

After being negative from 2014 to September 2022, the sharp rise in interest rates and earlier-than-expected repayment of Targeted Longer-term Refinancing Operations (TLTROs) led to an increase in the cost of funding on the capital market.

Against the backdrop of persistent inflation in the Eurozone, the ECB continued its aggressive tightening of monetary policy during 2023, delivering a tenth successive rate increase in September and pushing interest rates to their highest level since the launch of the euro.

Against this background, excess liquidity has fallen from record highs of close to €4.7 trillion in 2022 to around €3.6 trillion in December 2023 as TLTRO tranches have matured and as some market participants have made early repayments of their TLTRO holdings. Its Asset Purchase Programme (APP) is contracting at a “measured and predictable pace”, according to the central bank, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The ECB’s adjustment of the remuneration cap for non-bank deposits has also had an impact on European repo markets. Non-banks and new customers have contributed more liquidity to the repo markets, particularly since the ECB, acting through the national central banks, has offered a rate of only €STR-20bp on non-bank cash deposits since May 2023.

In addition, Deutsche Bundesbank has stopped paying any interest on deposits since 1 October 2023. “This development led to a further step up in the use of CCP repo on the part of public authorities,” says Frank Gast, managing director, Eurex Repo, and head of sales for Europe, FIC derivatives and repo sales. After a period of reduced activity, cash-driven repo transactions, especially those cleared through a CCP, are again attracting significant attention.

These macroeconomic drivers are prompting investors to revise their trading strategies and to reassess their positioning in the market. “Previously inclined towards short positions, investors have now pivoted to long positions in government bonds,” observes Gast. “This switch has had a dual impact: it has reduced the need to borrow securities to cover short positions and simultaneously heightened demand for financing.”

The practical effects of this change are evident in the declining average lending fees for core European government bonds year on year, notes Gast, coupled with a significant upturn in balances under collateral management, particularly in sectors where firms act as triparty agents.

Driving up the volume

Against this macroeconomic background of interest rate tightening, TLTRO repayments and further reduction of excess liquidity, Eurex Repo has continued to experience a rise in repo trading activity across its platform, culminating in new record volumes for its cleared repo markets.

Specifically, total average daily term-adjusted volume across all markets increased by 70 per cent relative to 2022, powered by a 38 per cent YoY rise in volumes in the special repo market and a 140 per cent increase for GC Pooling.

In general terms, Eurex Repo has focused its recent strategy on attracting more customers into cleared repo, particularly from buy-side firms, on building GC Pooling trading activity, and on improving market share in the B2B special and GC repo segments.

These initiatives appear to be bearing fruit, with total daily term-adjusted volumes for buy-side clients rising by more than 200 per cent over 2023. “The revitalisation of this cash-driven repo segment was significantly influenced by the momentum in Eurex's buy-side and dealer-to-client strategy,” explains Gast. Sales initiatives designed to boost liquidity in French, Italian and Spanish government bonds in the special repo segment have, in addition, stimulated volume growth across a range of clients.

While there has been a pick-up in shorter maturity trades from overnight to one week, 2023 has particularly delivered a rise in term transactions which continued during the typically quieter trading months of July and August and has extended into Q4. In November, term-adjusted repo volume grew by 70 per cent and, on 28 November, the organisation recorded a new daily record of €1.53 trillion of term-adjusted volume in its repo markets.

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Managing director
Eurex Repo

Moreover, as its repo rates move closer to the ECB's deposit rate, Eurex Repo anticipates that an increasing number of banks will become involved as cash providers in 2024. Spreads between the GC Pooling ECB basket and the Deposit Facility Rate (DFR) narrowed from around 14 bps at the start of 2023 to 5-6 bps by year end.

For the GC Pooling EXT basket (the GC Pooling ECB EXTended basket, which covers approximately 10,000 ECB eligible securities) spreads have fallen to 2-4bps. Furthermore, the spread between the two main GC Pooling baskets contracted from about 10 bps during the first half of 2023 to 3 bps by December.

Adding new participants

Eurex Repo has established an expanding community of buy-side firms, supranational agencies, corporates and non-financials in its programme, with new cash providers joining the programme drawn by attractive yields. This has included a growing number of pension funds.

For the sell side, firms continue to be driven by a need to optimise their balance sheet efficiency — meeting their financing requirements in line with risk-weighted asset (RWA), liquidity coverage ratio (LCR) and net-stable funding ratio (NSFR) obligations under Basel III. Under a major update to global capital standards, commonly labelled the Basel III Endgame, firms are still able to apply advanced approaches for their RWA calculations for credit and operational risk, but banks applying internal modelling are now under pressure to adopt standardised modelling for a significant portion of their operations — which must exceed 72.5 per cent by the end of 2026, with an intermediate target of 55 per cent by the first quarter of 2024.

These significant changes to the Basel risk-based capital framework are prompting sell-side firms to examine new liquidity sources and to reassess the viability of principal models and CCP-cleared solutions.

Eurex has also introduced a dedicated programme over several years designed to attract more buy-side clients into European cleared repo and to enhance buy-side clearing access for a wider set of instruments including exchange-traded and OTC derivatives. Through ISA Direct and ISA Direct Indemnified, Eurex Clearing aims to combine the advantages of direct clearing access for buy-side firms with the benefits of traditional sponsored access via a clearing member. This establishes a principal-client relationship between the buy-side firm and the CCP, but with a clearing agent performing additional service functions to enhance the clearing solution.

With these benefits, Eurex added 17 new trading and direct members to its financing programme during 2023, with more than 20 prospect clients expected to join the programme next year. More firms are coming into the market for cleared repo, notes Gast, providing access to liquidity at affordable rates, offering straight-through workflows and an effective risk management framework around the transaction.

"This is attractive from an execution and an operational standpoint, enabling participants to do cash management for perhaps billions of euros against a broad choice of counterparts," he continues. "By using Eurex Clearing, cash lenders are able to position their cash promptly and efficiently against a wide range of repo borrowers, perhaps taking 20 or 30 minutes to complete these secured lending commitments when it might have taken them the entire morning to do so bilaterally."

On this point, recent experience has underlined that buy-side firms and banks need to continuously evaluate their liquidity management strategies, both under normal operating conditions and during crisis scenarios. "Recent crises have highlighted the benefits of using a CCP not only for its risk mitigation capabilities, but also for its streamlined settlement infrastructure," Gast observes. In a bilateral framework, settlement processes can often become unnecessarily complex and more vulnerable to disruptions.

Strategic lending

Building on these observations, Marton Szigeti, head of collateral, lending and liquidity solutions at Clearstream, indicates that Deutsche Börse Group offers a comprehensive portfolio of funding and financing, securities lending and collateral management solutions that are helping users across the financial ecosystem to manage the macroeconomic, regulatory and operational challenges that confront them.

"Clearstream offers a strategic lending programme where we stand as a contractual counterparty to lenders and borrowers," explains Szigeti, "thereby offering the advantage of trading against an AA-rated financial market infrastructure company as intermediary."

"We believe that it will become increasingly hard for some firms to access the liquidity they require without intermediation to help them to manage the credit risk," says Szigeti. "With this, we see growing interest in our strategic lending programme, given the favourable capital treatment this can create."

In line with this statement, he notes that securities lending volumes through Clearstream's programme are up approximately 40 per cent over 2023. However, the profile of this loan activity is changing, with a contraction in specials-driven loan activity to cover short positions or to support event-driven investment strategies. Instead, loan demand is being heavily driven by firms sourcing securities to power their financing strategies and to meet their obligations to hold liquid asset buffers under LCR or NSFR.

"In monetary policy terms, there are signs that we are now near to the end of the tightening cycle and, with this, traders are changing short strategies to long strategies, thereby reducing the associated demand for stock borrow to close out short positions," comments Szigeti.

"In turn, corporates and buy-side firms are being well paid to lend their inventory of stress-compliant assets," says Szigeti. "With this, many of the corporate entities that we have on Clearstream's books are becoming increasingly active in the securities lending space."

In expanding its lending programme, Clearstream is adding ETF lending to its services during Q1 2024. This asset class expansion is not only extending the range of securities and loan availability offered through the fails coverage programme, but also makes a wider pool of securities available to clients via the strategic lending programme.

For lenders, this will, among other benefits, provide opportunities to enhance portfolio yields and to deliver additional liquidity to the market. For borrowers, this will provide access to ETF securities for strategic trading purposes and will extend fails coverage to boost settlement efficiency in ETF secondary markets.

Settlement discipline

With the introduction of the Settlement Discipline Regime component of the Central Securities Depositories Regulation (CSDR) on 1 February 2022, this has reinforced demand to borrow securities for fails coverage purposes. In doing so, it has also motivated firms to review their operational cultures, changing how they monitor and manage

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potential fails — particularly by adopting an intraday approach to their fails coverage.

Szigeti observes that prior to SDR — and during an extended period of low interest rates — it was relatively common for firms to autoborrow the securities and then to hold these securities overnight before entering them for settlement in the next settlement cycle. “Whereas in the past, perhaps 50 to 60 per cent of securities borrowed to cover a non-delivery would be held overnight, this has now fallen substantially — to no more than 20 per cent,” says Szigeti. “This is a major efficiency consideration, and a major cost saving, when considering that billions of euros of trades are being borrowed on a daily basis.”

On balance, many settlement counterparties — particularly on the sell-side — are monitoring the status of their trades much more closely across the settlement cycle, they are identifying potential fails at an earlier stage and are acting more quickly to close out those failed positions or to apply functions such as shaping or partial settlement.

Market outlook

With the expectation that interest rates are stabilising and are likely to fall, Szigeti predicts that buy-side firms will continue to adjust their trading strategies, reducing their short positions and increasing the balance of long positions in their portfolios. This shift in investment strategy implies that fewer special securities, which typically command higher fees, will be in demand, especially in the government bonds sector. Instead, there will be a heightened need for financing solutions.

A key focal point, he suggests, will be the potential leverage employed by the buy-side in basis trades, particularly involving government bonds through central counterparties. The introduction of haircuts as a means to limit leverage could have a significant impact as it can affect both liquidity and cost of financing.

Eurex Repo will continue during 2024 to expand its product coverage and to extend the range of participants active on its platform, indicating that a diverse and well-balanced composition of participants is essential to enhancing the strength of the liquidity pool and to supporting a robust and sustainable funding framework for repos and reverse repos.

"Beyond the current blend of commercial banks, national debt management offices (DMOs), central banks, supranational entities, and, more recently, pension funds active in Eurex's repo markets, our aim is to further extend the pool with the inclusion of entities such as insurance companies, money market funds, and hedge funds," says Gast.

In the case of hedge funds, the ISA Direct Indemnified solution offers direct access to the clearing house and the first pilot clients are expected to complete their onboarding during Q1 2024. "We have conducted detailed discussions with clearing agents and have several clearing agents that have, or are about to, upgrade their clearing membership to offer this service to hedge funds," says Gast.

This, he suggests, is an important step for Eurex Clearing in moving its buy-side strategy to the next level. Buy-side clients currently contribute approximately 10 per cent of current volume to Eurex Repo and the firm expects this to grow, with more hedge funds coming on board, to around 20-25 per cent of volume through its programme in 2024.

EMIR 3.0 negotiations have also opened a window to remove further barriers for the buy side to access repo clearing through targeted amendments to the Money Markets Fund Regulation and the UCITS directive. In June 2023, the exemption for EU pension funds from the clearing mandate finally lapsed after several years of extensions.

For the bank community, State Street selected Eurex in May 2023 as the first location outside of the US that it will use for trading and clearing repo transactions. In September, the Bank of New York also joined Eurex as its first non-US CCP for clearing repo trades. Commenting on these developments, Gast observes that "onboarding two of the world's largest custodian banks has been an important milestone for Eurex's cleared repo markets in the past year and illustrates the huge opportunities that exist in the European repo market".

Eurex aims to continue to drive momentum through GC Pooling by adding new functions and new participants. In December, it launched a "break-date" term-trading solution that will enable traders to book a term trade, but for this to be segmented and rolled over as a series of monthly transactions, helping the client to maximise balance sheet efficiency over reporting dates. "This provides an example of how we want to support the market, helping banks and broker-dealers to manage their balance sheet more efficiently," says Gast.

More generally, the focus at Eurex Repo is to be home of the euro yield curve, offering cross-product coverage within the euro currency for repo, exchange-traded and OTC interest rate derivatives. Eurex is one of the few places where participants can trade term repo up to 18 months. Eurex Repo also aims to grow its market share for repo financed against a wider range of EU government bond issuers, including Spanish, Italian and French government bonds.

An important development to watch, notes Gast, is that Eurex Repo will be introducing cross-product margining between its fixed income futures and repo markets. For buy-side clients that are users of fixed income derivatives, this will provide a prime opportunity to extend into repo financing and to benefit from margin offset across these cleared trading exposures. "Eurex Clearing is in prime position to facilitate this, given that we have a lot of buy-side firms already actively trading on Eurex in the futures markets," says Gast.

It also identifies opportunities to expand its solutions coverage for ESG financing and green repo. Deutsche Börse supports a number of issuers — particularly supranationals, development banks and finance agencies — that are keen to build liquidity in secondary markets and to promote an active repo market for green bonds and social bonds. In catering for this appetite, Eurex Clearing and Clearstream have developed green bond GC baskets — which they suggest are the first standardised green general collateral baskets available in the market.

From a Deutsche Börse perspective, the acquisition of an 81 per cent share in governance, ESG and analytics specialist Institutional Shareholder Services (ISS) has enabled the Frankfurt and Luxembourg-based market infrastructure company to make ISS' ESG ratings available for collateral eligibility screening on Clearstream's collateral services platform, the primary collateral engine supporting the ICSD's securities lending and collateral management services. "We believe that ESG as a trading factor will continue to increase and we are continuing to invest to facilitate this expansion," says Szigeti.

Additionally, Eurex plans soon to launch EU bond futures and to support growth in secondary market trading in EU bonds. "The prerequisite is whether there is a liquid cash market and a liquid repo market to provide the foundations for a liquid futures market and to make this successful," says Gast. "We are collaborating on this development with the European Commission and our clients and this will be an important part of our schedule for 2024 and beyond." ■