Julia: Hello and Welcome to a DerivSource podcast.

I'm Julia Schieffer, the founder and editor of DerivSource.com.

Today we are reviewing the recent published 29th semi-annual survey of the European repo market, which was released by the European Repo Council of the **International Capital Market Association** or **ICMA**.

What's interesting about this survey is that the baseline figure for the market size shows stability in the repo markets however; we are warned that this stability is misleading.

I have with me today **Richard Comotto**, senior visiting fellow at the ICMA Centre and author of the report who's going to shed some light on this survey and explain the findings in more detail.

Welcome to the podcast, Richard.

Richard: Thanks Julia.

Julia: **Richard, you are the author of the ICMA 29th semi-annual survey of the European repo market. Can you start by giving us some background on this survey before we get into the most recent results?**

Richard: The survey has been going for 15 years now, we started in 2001. It was an initiative by the European Repo Council which is a committee of the International Capital Markets Association that is responsible for the repo market in Europe, that represents the repo market in Europe.

The intention was to provide some insight into what was then a very rapidly developing market and we have, as a result, the only really authoritative figures on the European Repo market. In fact, probably the best picture of any repo market in the world. So we've been pursuing it for 15 years, it's been gradually refined and eventually we have a product, which is fairly unique.

Julia: The headline figure set out by the survey is the amount of the repo business outstanding on June 10th 2015. And in the most recent report this baseline figure for the market size is 5,612 billion Euros.

Richard, can you explain these figures and why the recent report shows the repo market remains steady, despite warnings that the steadiness is in fact misleading?

I think we have to step back a little and look at the trend. Since 2010 / 2011, the market has trended downwards at a slight rate, and all we're seeing in June 2015 is just a fluctuation around that trend. So the market is well below its pre-crisis peak, well below the level to which it recovered after the crisis, and we see in December and January when we do our surveys, we just see slight upticks, slight downticks, but it's really heading downwards.

The big question for us is we had expected rather more of a downtick, or in fact even an acceleration of a downward trend, and that's not apparent yet. The expectation that we had, that's shared by people in the market, is that the weight of new regulation, particularly the leverage ratio and things like the forthcoming net stable funding ratio, that these will gradually depress market activity as they came on-stream, and that other regulations such as the forthcoming total loss absorbing capital requirement would reinforce that trend, and that we would really follow more of a trend that we've seen in the US market, where since 2012 we've seen a fairly sharp downward fall in the market.

If you are using Reserve Bank of New York primary dealer figures and those are now less than $4 trillion Dollars. That's a clear and distinct and quite sharp downward fall. Europe, we are going slightly downwards, sideways a bit, but just slightly downwards, so why haven't we seen the same decline? I think in the US, regulatory pressures have been distinctly heavier; repo, and in fact all short-term wholesale funding, played a more important part in the financing of US securities deals and the regulators in the US have been very keen to reduce the importance of short-term funding.

In Europe, where investment banks are often associated with commercial banks, there's been less reliance on short-term funding, but still we expected a similar sort of regulatory pressure to be exerted.

The problem when we look at any individual figure, or even a couple of quarters' worth of figures, are that we're seeing the net results of a number of complex factors. So there is regulatory pressure there with a lot of anecdotal evidence to that effect, but in the first half of 2015, the market was quite buoyant so it appears that that would have counteracted some regulatory pressure.

In addition, in a later survey it would appear that a couple of, well several large EuroZone banks have taken the opportunity to expand their balance sheets quite significantly. Repo books are quite volatile, they can increase and decrease very rapidly over shorts period of time. But on this occasion we're wondering why these banks have taken the opportunity, or why have these banks increased their repo book against what we've seen as a trend, and it would appear that probably most banks have anticipated a lot of the regulatory requirements that have been announced; they're meeting them much earlier than the regulations require them to, and they've got some leeway. It may well be that there are opportunities in the first half of 2015 which these banks decided they could afford to exploit without losing control of their balance sheet.

Julia: **Just expanding on that a little bit more and focusing on the banks, what is their general strategic response and how are they implementing regulation?**

Richard: The regulations that are really sharply affecting the repo market, I mean there have been general increases in capital requirements for risk, but the regulations that are targeting repo are the leverage and liquidity regulations, so the leverage ratio, the liquidity coverage ratio, the net stable funding ratio, these are the key pressure points on the repo market.

What banks have been doing… well, these regulations have the effect of making repo more expensive, so the leverage ratio significantly increases the risk capital charge for repo. Repo is a very attractive instrument if you take into account the collateral and the reduction of the risk due to collateralisation on a risk-weighted basis it's a good product. If you take away the benefit of collateral then it's something that uses up a lot of balance sheet but is low margin, so it's much less attractive.

The leverage ratio takes account of repo and ignores the collateral angle, so it significantly increases the capital charge on repo.

The liquidity coverage ratio is fairly neutral for good quality collateral but if you're trading things like corporate bonds then it also increases the capital charge. The net stable funding ratio which is intended to ensure that banks don't mismatch their maturities too much, that also makes life a lot more difficult if you're trying to intermediate in the repo market between sources of funds and uses of funds, and vice versa, sources of collateral and uses of collateral.

Banks have had to stand back and say repo is much more expensive, we probably can't increase our bid offer spreads as much as we should in order to cover the increase in costs, we're going to have to ration repo and that means giving it only to customers who in total are generators of revenue and profit for the bank. The challenge for banks of course is to discover who those customers are, and I think in the last year or so we've been seeing banks implementing new systems to add up the revenues and profits provided by particular customers so that they can make those decisions. They're dealing with customers now on a much more holistic basis, and repo has become a loss leader; it's an essential service that you have to offer, but you only do it if you think that you're recovering your cost from other products that you're able to sell the customer.

I think we're seeing a shift, we're seeing a very selective reappraisal of the business that banks do.

Julia: **For the repo professionals and collateral managers who read DerivSource, what do you believe to be the key takeaways of this report that you'd like to share with them, and why?**

Richard: I think at the moment we have to say that the market is flat-lining, crawling sideways, trending down slowly, however you want to characterise it. It's certainly not growing, and it certainly won't grow. I think the question is whether that slight sideways, slight downward trend that we're seeing at the moment, that we've seen since 2010 / 2011, whether that's actually going to suddenly descend, whether there's going to be an acceleration of the downward trend to follow the US market, whether in the fact the weight of regulation will reach a critical point at which lots of banks decide either to end the business or to severely curtail their activity.

I would be advising considerable caution about the future of the market. If this does happen, then there are going to be knock-on effects into liquidity of securities markets and derivatives markets, and I think we may get some official reappraisal of the weight of regulation and regulatory approach because governments are going to be asking why they're paying more for their money; companies are going to be telling regulators "well we can't raise money cheaply any more". Initiatives such as the European Capital Market Union are going to be undermined by the inability to issue corporate bonds.

I think there will be a period of time before this happens, so it could be quite a difficult period. If the market carries on going sideways then people have got time to adjust, but I think it just delays the inevitable questions that have to be asked. So for repo professionals, it's focusing the business, being much more selective about what you do with your balance sheet.

For customers of banks it's going to be the ability to access the repo market through your bank, or through any bank, that's going to become a lot more difficult.

Julia: **So you've just outlined some of the warnings for how the repo market in Europe is likely to contract in the future, but how do you think that the repo market will change in 2016 specifically? What do you see for the next 12 months ahead, Richard?**

Richard: I think the overall answer is I imagine it will stay more or less in the range that it's been in the last couple of years, so about 5.5 trillion. It's possible that being the end of the year we'll get a slight downtick added to that because end of the year people reign in the balance sheet.

Looking ahead, the worry is that we're going to see an acceleration of what is currently a slight downward trend. That the weight of regulation is going to reach critical point and that a lot of banks, having assessed their repo business over the last couple of years, will be in a position and have made a decisions, and that some of them will leave the business, most of them will curtail their activities. They will be a lot more selective about what sort of business they do and with whom, and that will all come together and we will see a sharp dip in the market.

Probably that will happen in 2016 / early 2017, but it could stretch a little further, but I think that's the probable horizon, because that's when we're getting close to the final deadline for a lot of regulations to be fully implemented. 2018 is sort of the end date for this.

Now if and when this happens, I think there's going to be a period of reflection by regulators or their political masters, because it's going to be very difficult with a shrunken repo market to issue government debt in large quantities as efficiently as it's done now. Plans such as the Capital Market Union in Europe which were intended to encourage companies to move away from bank financing and issue corporate bonds, they're going to be far more difficult to implement because corporate bonds will be a lot more difficult to sell, a lot more expensive. We may get people sitting back and thinking I hope we've got the balance right, but in between any official response or readjustment of regulatory pressure where we are now could take quite a significant amount of time.

No-one is going to be in a rush to unwind the regulatory measures of the last few years, but the effect when it comes could be quite dramatic.

Julia: **Thank you for your time Richard and for sharing your insight with us today.**

To find out more about this topic please visit the DerivSource podcast notes page. We will include a link to the ICMA survey there.

Thank you for tuning in. Join us next time.