Julia: **Hello and welcome to this DerivSource podcast. I'm Julia Schieffer, the founder and editor of derivsource.com.**

The International Capital Markets Association or ICMA has published the results of its most recent survey of the European repo market and the findings may indicate that the European repo market is in fact recovering from the liquidity crunch the market experienced late last year. [Read report]

Here to walk me through the highlights of this survey and possible implications on the repo market going forward is Richard Comotto, advisor to ICMA and senior visiting fellow at the ICMA center at Reading University. Welcome to the podcast Richard.

Richard: Thank you Julia.

Julia: **The latest ICMA survey on the repo market suggests that the market may be recovering from the lack of liquidity seen at the end of 2016. Do you believe that the market may be recovering and, if so, why?**

Richard: I think we have to assume it is. There are always seasonal influences at the end of the year. A reduction in people's books for reporting purposes. So we always get something after that, but whether it's a trend is much more difficult to say. But given the unusual disruption in the market at the end of 2016—we've seen a partial repeat at the end of March but things have calmed down—I think we've obviously got over that particular problem for the moment, so there's going to be a rebound. In addition, when we looked at the numbers, the expansion in repo books has been so broad that the large majority of participants were increasing the size of the repo books. Given the breadth of that expansion, it does suggest that there is a powerful driver behind the market.

From anecdotal evidence, it looks as though the recovery is continuing over the second half of 2017, but of course we don't know what's really going to happen at the end of this year, whether we'll have a repeat of the end of 2016, whether people are going to be reacting to another wave of regulations that's coming along. We have actual implementation of a number of initiatives in 2018. How much people have anticipated those new regulations, how much that's built in to the market already is difficult to say. But I think it's a fair guess from what evidence we have that there is a broad-based recovery.

Julia: **So Richard you've already touched on what we might expect at the end of this year. Can you elaborate a little bit in terms of what you think the market should be doing in terms of bracing itself for a potential liquidity crunch at the end of this year?**

Richard: Well, this is the $64,000 question. I think some of the factors behind what happened at the end of 2016 are absent, for example, at the moment it doesn't appear that we're going to have the same yen basis driver that we had at the end of 2016—we think. So some of the forces that exaggerated what happened at the end of last year may well be absent or more muted. But there's also the possibility that people have learnt, they are better prepared. We see, even last year, a lot of firms getting business done from September/October in anticipation of the end of the year. Well I think they're going to be even more careful about approaching this year-end with business still needing to be done. So there might be a learning effect. We might be able to manage the situation better.

But it is really very difficult to say. A lot of firms have business they simply can't do in advance, so firms don't know. People like Money Market Mutual Funds have very short-term horizons. There's lots of business that really people don't know what they need until they get to the very end of the year. So there's always that. I mentioned the implementation of further regulations in 2018. One would expect that preparation for that is well advanced, but again, there is an awful lot of regulation, an awful lot of uncertainty. So I think we will get disruption. As to the degree, I would be surprised if it was as bad as at the end of 2016, but one can't rule that out.

Julia: **And going back to the survey itself Richard, looking at the other findings, were any of them a surprise to you?**

Richard: I think if we look at the general trends, we've seen these continuing. The migration of the market to more direct business, away from electronic trading and away from CCP clearing. Now I have to emphasize that our survey measures outstandings on a particular date, so a snapshot of the market of positions that exist at the end of business on the survey day. We don't measure turnover, so we don't measure the full flow business over a period of time. But looking at it from our point of view, we see this movement to direct business, which is going to be customer business. People clearly concentrating their balance sheets where they make most revenue, and moving away from relatively low margin interdealer business. And that's why we see less electronic and less CCP cleared trading.

That also appears to be a driver of the expansion of the market in the first half of this year as shown by the survey, so that's clearly an important structural trend, focus on franchise. In addition, we see evidence of hub-and-spoke structure of the market, where a lot of the collateral comes from the core investment banks, who are essentially London based. And cross-border business in and out of the Euro zone is evidence of that structure. That obviously raises interesting questions about how the market will re-adjust post Brexit, given the structural form it appears to be taking at the moment.

The single most interesting fact for me is the decline in tri-party repo. Part of that in our survey was due tothe loss of one of our participants temporarily. They'll be back in the next survey but one of them dropped out. And they were quite a large user of tri-party, so we expected to see a fairly small fall in tri-party because of that. But even adjusting for that participant falling out, the decline in the share of tri-party repo was quite surprising. It's probably one of the smallest shares we've had since we've been doing the survey. And that's not consistent with anecdotal evidence that has been picked up over the couple of years, of more people coming into the market, non-bank financials coming into repo and using tri-party repo as a route in. Now it may be that our perception of tri-party is distorted because we survey essentially banks, and it may be that non-bank financials don't entirely appear on our radar screen. But it's still quite unusual given the size of the reduction in tri-party.

Now some people have suggested that it's just a reflection of the amount of liquidity in the system, particularly central bank liquidity as a result of QE, that there is so much money around that there is far less need for GC financing through the repo market. It's certainly true we've seen a decline in things like Eurex's Euro GC Pooling, which is a part of the tri-party repo market, but now it appears to be having an effect on tri-party repo more generally. I note in contrast that tri-party securities lending, on the other hand, appears to be doing very well. So I think that's the single biggest surprise, the size of that reduction in tri-party.

Julia: **Now one of the survey findings relates to the demand for high quality liquid assets, which are unsurprisingly in high demand given the rise in margin requirements as a result of new regulation. How will the repo market evolve given this demand is set to continue?**

Richard: In our previous survey in December 2016, we saw a big jump in maturities of one to three months, and that is generally interpreted as demand for high-quality liquid assets that people borrow for that sort of period in order to meet their Liquidity Coverage Ratio requirements where they are doing business up to 30 days. That share of one to three-month business fell back in the latest survey understandably, because people obviously focused on HQLAs for reporting purposes at year end . But I think there are two impacts on the repo market: where people use cash for variation margining, for example, or where people need to acquire non-cash collateral and need collateral transformation to get out of collateral that they have into collateral that they need. So it's the two sides of the repo market that will be affected.

The volume of initial margin and variation margin that's been reported by various bodies, is obviously having an impact on repo, but I think people are being a lot more efficient in the management of their margin requirements. So the effect on repo has not been quite as large as might have been expected. But one thing is for certain it's going to continue and continue to grow so that there will be an influence. But on both sides of the business, cash and collateral.

Julia: **And my final question for you Richard is, what do you expect to be the biggest influencer of the repo market in 2017? Will it continue to be regulation for instance?**

Richard: I think regulation inevitably will dominate the agenda for the repo market. There is speculation that there might be some recalibration of some regulations like NSFR, and possibly CSDR. The suggestion is, for example, that the mandatory buy-in requirement under CSDR, which has been delayed in effect for two years, may actually be removed at the end of the period, or whenever it's scheduled to come in, it may actually be removed before then. That will be quite important. If it goes ahead that will have a very, very important impact on the market. There's NSFR as well that really a lot of people have only started to think about that in the last year or so. So that's going to have serious impacts. If it's recalibrated that may moderate the effect. And then in the background we have SFTR, the Securities Financing Transaction Regulation, which requires reporting business in detail to a trade repository.

Given experience with EMIR, given the problems in the way that SFTR has been drafted, and just given the sheer volume of information that has to be reported and the accuracy that is required, I think that's going to be a drag on the market for the next year or so. A lot of resources arebeing switched into that. So regulation, inevitably in one form or another, will be top of the list I think of things influencing the way the market goes.

At the moment we appear to be on a bit of an up curve in terms of volume, so people are getting a little bit more comfortable with the regulation that's already been imposed. They're adjusting to it and they're obviously anticipating the next wave. And then I think next on the list must be Brexit, given the role that London plays in the repo market, given the location of repo clearing in London I think that's clearly number two on our list. It may temporarily rise to number one. So I think those are the key influences.

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

Richard: My pleasure.

Julia: **For more information on the ICMA survey please go to the show notes page on derivsource.com. Thank you for listening. Join us next time.**