IMPACT OF RECENT REGULATION ON REPO MARKET ACTIVITY FROM THE PERSPECTIVE OF A NON BANK PARTICIPANT

redefining / standards

Key Takeaways

- **Repo is a key tool for Insurance Companies to manage duration & liquidity risks**
- **The Repo market is largely impacted by current financial regulatory changes**
- **IC will be impacted directly and indirectly**
- **IC will have to adapt the way they use Repo and find alternatives**
- **Regulation will force IC to do more Repo & to bear systemic risk on it**

Impact for Insurance Companies

Impact of Basel III on repo market & impact for Insurance Companies

- Increase cost
  - *Based on a survey made by ICMA, the Balance Sheet cost for a bank to enter into a vanilla repo should be around 40-45 bp**
- Increase volatility
  - *More volatility in prices*
  - *Widening of bid-ask spreads*
  - *More differences between counterparties*
- Reduce liquidity & market capacity
  - *More and more difficulty to trade repo close and the end of quarter.*
  - *Less counterparty*
- Difficulty to secure costs and reduce rolling risks
  - *Increase cost for long term transactions*
  - *Limit collateral diversification capacity*
- Increase fragmentation between cash & derivatives markets
  - *Repo capital charges create distortion in the bond and collateralized loan market*
  - *Equity basis spread (difference between SX5E Index and cash component)*
  - *Swap spread volatility*

Regulation will force IC to find alternatives to manage their duration risk

* Perspectives from the eye of the storm, ICMA Nov 2015

Impact for Insurance Companies

- **Impact of SFTR & Collateral Reuse Regulation:**
  - More reporting
  - Limit liquidity optimization in dedicated investment vehicles
  - Risk to be perceived as collateral re-user & over leveraged
    - > *Collateral re-use calculation methodology is still under discussion (FSB Feb 2016 consultation paper)*
    - > *Some of the investigated methods (Indirect approximation method) could lead to flag non collateral re-users as re-users.*

- **Impact of Financial Benchmark Regulation:**
  - IC could benefit from consistent benchmark between different short term money markets references
    - > *Money Market investments Vs funding costs Vs Derivatives reference indices Vs IC liabilities are indexed to Euribor*
    - > *Risk of inconsistency have to be monitored (*

- **Indirect impact from other regulations**
  - EMIR & Derivatives regulation
  - Derivatives will required more cash collateral
    - > *Government bonds as collateral will be refused by banks*
    - > *Clearing requires more cash as collateral (VM)*
    - > *Margining for non-cleared OTC will increase the need for collateral;*
  - IC will be forced to make Repo to post cash collateral to banks
    - > *IC will provide cash to Banks*
    - > *IC will bear a systemic risk on Repo*

Regulation will force IC to do more Repo & to bear systemic risk on it

Potential opportunities

- New regulatory will create a price for Leverage & Liquidity within Banks Balance Sheet
- Long term investors could potentially monetize their leverage & liquidity capacity

Necessary?

Insurance Companies could potentially benefit from market opportunities

Annex

Difference between Banks & Insurance Companies

Banks

- Repo is the banks main source of money market funding in Europe*
- Banks have tools to net positions trough CCPs (60% of the € interbank repo transactions are conducted via CCP based electronic trading*)
- Banks are two way users
  - *Fund cash*
  - *Re-use collateral*
  - *Optimize Liquidity (LCR)*
- Banks have access to Central Bank liquidity facility

Insurance Companies

- Repo is used to manage duration & risky duration in an efficient way
  - *3,5% of Balance Sheet on average*
- IC are making bilateral repos with Banks
- IC are one way users
- IC have no access to Central Bank

Insurance Companies are one way user with less room for optimization than Banks

*Source: “The Euro Interbank Repo Market” March 2014 University of St Gallen

Use of repo from an insurance perspective

- An IC Balance Sheet is composed
  - Mainly of govies & IG credit bonds that will provide the core of the return (80% for European Insurers)
  - Other assets for diversification (High Yield, Loans, Real Estate, Equity, Hedge Funds, …)
  - Derivatives for ALM hedging and tactical purposes because investment products have embedded options
  - And Repo

- Why using Repo?
  - IC have long term liabilities toward their policyholders
  - To manage the Interest Rate duration while managing independently the risky duration of the investment portfolio, IC are :
    - *using repo to make duration with government bonds*
    - *investing in credit bonds with relevant maturity to control risk*
  - Repo is also considered as an emergency tool to access liquidity in case on extreme liquidity crisis
  - Repo is efficient from a cost and accounting point of view

- Size of the repo bucket
  - IC use of repo is relatively limited
  - 3,5% of Balance Sheet on average for the top 12 French Life insurers represents (58b€ in total)*

Repo is a key investment tool and is part of our risk management process.

*Source: ACPR March 2016: "Suivi de la colecte et des palcements des 12 principaux assureurs-vie à fin décembre 2015"

How to adapt

- Alternatives
  - Use Total Return Swap to manage duration and avoid banks BS costs
  - Investigate new source of funding

- IC have to follow market evolution and especially CCPs development
  - Innovation is starting around Balance Sheet optimization (compression, netting capabilities,…)
  - Market evolution
    - *Collateral versus cash market toward a collateral versus collateral market*
    - *Electronic solutions and automation*
    - *More & more standardization*
  - CCPs current framework has been develop for banks
    - *IC are one way users with limited netting needs*
    - *Banks BS costs are passed trough end users*
    - *Tri-party repo framework is difficult to implement*
  - Risk related to CCPs Resolution regime are still uncertain & moving
    - *Banking & CCPs resolution authorities shall exercise write-down and conversion powers in relation to liabilities arising from repo*
    - *Local transposition creates uncertainty and may strengthen market fragmentation*
    - *Effective exposures upon default of banks and CCPs are unknown to the end user which potential infinite exposure.*
  - Follow CCPs offer development …

Insurance Companies will have to adapt the way they manage their BS

How to adapt: Follow CCPs offer development …

- IC have to follow market evolution and especially CCPs development
  - Repo market is adapting with the emergence of clearing offers for the buy side
  - CCPs are developing sponsored membership
    - > *Ease buy side to access repo clearing*
    - > *Facilitate netting for banking counterparties*
  - Example of LCH sponsored membership
    - > *Tri-party relationship between Sponsored Member, Agent Member and the CCP*
    - > *Transactional relationship remains between Sponsored Member and the CCP*
      - Sponsored Member must meet required eligibility criteria
      - CCP has to perform credit analysis and regular due diligence on Sponsored Member
    - > *Agent member contributes to the default fund and additionnal ressources on behalf of its client*
      - They enter into the waterfall of the CCP
      - They are accounted for in the determination of the leverage ratio but represent a small portion of repo notionals
    - > *Margining is processed by the Agent Member acting as paying agent or margin lender for the sponsored member*
    - > *Sponsored Member shall select several Agent Members to ensure backup in the event of an Agent Member default*

IC will have to assess if Agent Members are willing to commit on the long term

Current regulatory changes

- **Basel III** impact the capital required for repo transactions
  - **Basel III Regulatory Capital dimension:**
    - > Leverage Ratio & Supplementary Leverage Ratio (**LR/SLR**) => require banks to mobilize capital against on and off balance sheet usage (incl. REPO and derivatives) with additional capital requirement for US G-SIBS**
  - **Basel III Liquidity Management dimension**
    - > Liquidity Coverage Ratio (**LCR**) => requirement to hold high quality liquid assets to withstand a 30-day funding stress
    - > Net Stable Funding Ratio (**NSFR**) => longer term ratio addressing liquidity mismatch over 1 year

- **Securities Financing Transactions Reporting & Collateral Reuse** will increase reporting and transparency
  - > Reporting obligation: on SFT and TRS no later than 1BD following conclusion of the transaction
  - > Transparency towards investors: UCITS and AIFM shall inform investors of use of SFT and TRS
  - > Transparency of reuse: rights of reuse under collateral arrangements shall be subject to information of counterparty of risk and consequences of reuse and prior express consent of counterparty

- **Financial Benchmark Regulation** will develop new benchmarks for repo & credit products
  - > Still at discussion level
  - > FSB recommend EMMI* the development of transaction based secured money markets benchmark as a complement to a transaction-based unsecured money markets benchmark since 2013

The Repo framework is largely impacted by current regulatory changes

 *EMMI: European Money Markets Institute