

# Panel: Repo

Our panel debate this issue covers repo trading and the quality and supply of securities are the focus topics...

## 1. Will the quality of bonds be of greater importance for the rest of this year for repo market trading?

ASTANIN: Yes, it will. In the period of the global financial crisis the credit risk of bond issuers would be one of the main factors which determine investor's appetite to buy bonds and use it as collateral in repos.

WYLLIE: The quality of the securities involved in the repo transaction dictate whether or not a trade is executed. Participants have remodelled their cash reinvestment programs using a far more conservative approach, where highly-rated, liquid securities are the preferred investment option.

There is definitely a flight to quality with a focus on the diversification of repo collateral. Counterparty risk and the value of contract assets are also impacting the amount of repo trading taking place. Volatility in credit markets has reinforced the commitment to enhanced risk management, forcing clients to review portfolio guidelines to determine their appropriate tolerance for risk.

BALDWIN: This is not a simple question to answer, as the issue is multi-dimensional. Quality of underlying collateral has always been an important factor in the repo market and will remain so. However, since the beginning of the market turmoil almost two years ago in August 2007, there has been a re-assessment of the relationship between collateral quality, counterparty risks and also liquidity in the underlying asset markets under varying conditions.

Going forward, the risk adjusted return is likely to be at more tenable levels for all market participants than was seen just prior to the turmoil as counterparties re-assess the particular areas of the repo market they have both the expertise and appetite for.

The most active areas in the repo market are likely to remain in the higher

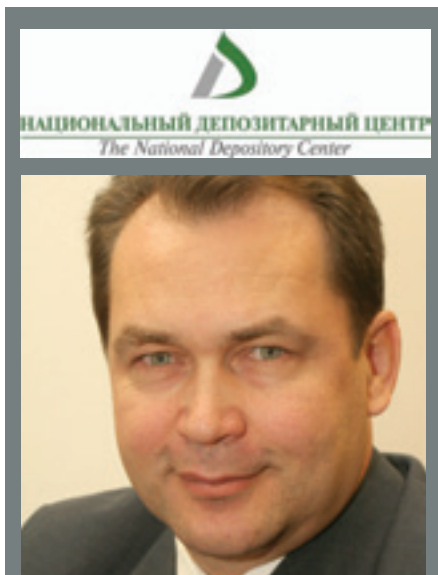
end of the collateral spectrum.

MITCHELL: The quality of bonds will remain of great importance but not necessarily of greater importance for the rest of the year. Those that accept non Government bonds as repo collateral have in most cases adjusted their acceptable criteria and are comfortable with the liquidity and pricing of the underlying issues.

## 2. Repo trading in government bonds increased to 84.7% from 81% according to an ICMA survey. What areas of corporate bonds might investors consider taking as collateral and what would be the considerations behind it?

ASTANIN: Talking about the Russian repo market, it seems that new corporate bonds and Eurobonds of state (or quasi-state) companies such as Vnesheconombank, JSC VTB Bank (Vneshtorgbank), JSC «GAZPROM»/GPB OJSC (Gazprombank), Savings Bank of the Russian Federation, Joint Stock Company "Russian Railways" and others would be used effectively as collateral in repo. The reason is their very low credit risks. Some of these companies have issued new bonds in 2009 and have announced to do it in the future.

WYLLIE: The continued flight to quality is apparent in this recent survey suggesting government backed bonds are still the preferred repo investment. Investors seeking incremental alpha may choose to consider corporate paper providing the underlying security meets the client's specific risk parameters. An expansion into investment grade corporate bonds but limited to the most liquid, highly rated paper is likely. The determination will still need to be based on other factors such as counterparty risk, collateral quality, liquidity of security and price transparency as the key components of corporate acceptability.



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Tony Baldwin is head of short term interest rates and funding at Daiwa Securities SMBC Europe. The firm is based out of London and its operations are currently split into four different areas: equity, fixed income, investment banking and derivatives.

BALDWIN: Understanding the collateral quality and the liquidity of the underlying asset market is key to the repo markets and investors are continuing to look at this carefully.

The number of corporate bonds that are eligible for central bank operations has increased (on a temporary basis)



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Gareth Mitchell is EMEA head of securities lending trading at Citi. He joined Citi in January 2000 from Deutsche Bank where he managed European bond lending for the custody securities lending area.

Throughout his career, Gareth has participated in numerous industry groups, including the Bank of England Gilt Repo Sub-Committee.

and this provides an element of comfort for the banking system and repo liquidity overall. Government (including supranational, agencies, government guaranteed etc) issuance is increasing as deficits increase in the West. Therefore the mix of collateral available in repo markets is also changing from its previous balance.

Most rational investors will concentrate on the sectors of the market where they have most expertise and therefore confidence regarding valuation of collateral. Any inability to assess valuation or opacity in underlying credit of corporate bonds is likely to be a hurdle some investors will be unable get over.

**“The tri-party model is recovering well and has many positive advantages over less automated types of repo”**

**Tony Baldwin,  
Daiwa Securities SMBC  
Europe**

MITCHELL: The ‘flight to quality’ affected the repo market just as it affected all bond markets. As liquidity in corporate bond markets reduced dramatically, the willingness of investors to receive such bonds also suffered as it became very difficult to price the collateral.

Corporate bond liquidity has improved this year and some investors have looked at improving their returns by accepting corporate bonds as collateral. Investors, in specifying the acceptability of collateral, will at a minimum take into account the type of the bond (structured/ non structured), ratings, pricing age, concentration and margin requirements.

**3. Some claim the ‘unsecured’ forms of financing will decline in favour of the relative security of repo transactions. How do you assess this view as trading volumes start to**

**increase a little again – does it bode well for the repurchase market?**

ASTANIN: There are quite developed legislation, risk management and unified automated technologies on the security market. That is why it helps market participants and investors to run liquidity using repos, reverses, securities lending, collateral management. We see that Russian banks have appetite to provide securitisation business into the market. Also it sounds good that after the global financial market impact in the second half of 2008 to the first quarter of 2009 the Russian market turnover has started growing again. It means that some signs of market stabilisation and recovery have appeared. But we are aware that there is quite high level of uncertainty about the global economy perspectives. That is why we expect high level of volatility in the market. It may impede repo market recovering.

WYLLIE: The repurchase agreement market, which was severely impacted after the demise of Lehman Brothers in September last year, is showing signs of recovery as institutions and investors seek secured lending in an attempt to reduce risk. As volumes improve and credit markets stabilise, repurchase transactions will regain favour among participants and continue to play a vital role in financial markets. The unsecured form of lending will further decline as the focus in today's environment continues to dedicate stringent risk management practices and collateralisation of all underlying exposures. Regulators will seek to encourage more secured lending while restricting unsecured.

BALDWIN: The focus and reliance by money markets on “unsecured” forms of financing will likely decline going forward for a number of reasons. The Basel II accord creates an international standard to be used in creating regulations about how much capital market participants need to put aside to guard against the risks in the financial markets. Naturally, under these guidelines unsecured

lending is ascribed a higher risk than secured lending such as repo. As such the provision of unsecured financing is much less efficient from a capital perspective, compared to the secured lending environment.

Equally, risk considerations have come to the fore after the turmoil and are unlikely to abate in the near future, therefore further strengthening the case for a further move toward repo (and other secured financing) markets.

New participants (typically cash lenders) to the markets are also likely to favour repo, given the 100% credit risk inherent in the unsecured forms of financing. Finally in the midst of the crisis the unsecured money markets froze, whereas the repo markets (although strained) remained active in higher quality collateral. This should give investors confidence in the robustness of the repo market.

MITCHELL: The past two years has forced cash lenders to re-assess their exposures to banks and financial institutions and look at risk mitigation. Repo provides an extra layer of protection if a counterparty were to default. Due to this we have seen a number of new entrants to the repo market and many more considering how to get involved, especially from the corporate sector who have traditionally relied on unsecured bank deposits.

Repo is a more complex product than unsecured bank deposits. Legal agreements need to be negotiated with each counterparty. Systems are required to control the trading, trade monitoring, collateral margining etc. Experienced staff are needed to transact the trades and Risk/Credit staff need to understand the product. All of this can look onerous and the expense can outweigh the benefits. This has led Citi to launch their Directed Agency Investment Service (DAIS) which allows participants to easily enter the Repo market without investing in all of the above.

**4. The repo market has been a leader in the use of electronic trading, including occasionally through**

**a central counterparty or on an ATS – which has potential benefits in reducing certain risks. But what percentage of trades will remain, irreducibly, on a bilateral, relationship basis?**

ASTANIN: At the moment we can estimate it only theoretically because the repo market with CCP has not launched yet in Russia's financial market. However we feel there is quite strong market demand for this service and we are on the way. We expect that the MICEX Group will offer this service to the market participants by the end of 2009. In this case we think that the repo market with CCP will get 75-80% market niche in short-term.

WYLLIE: Repo is still traded in large volumes over the counter (OTC) which can lead to increased levels risk. However, these risks are still within acceptable levels and will not reduce the execution of trades completely between counterparties on a bilateral level. The "Know your client" rule along with relationship based trading will continue to represent a large percentage of the overall repurchase market. However, we anticipate CCP and ATS will continue to garner a larger role in the repo markets as dealers begin to expand their businesses, minimize risk and create greater price transparency.

BALDWIN: As ever it depends on the strength of the counterpart whether they be CCP or bilateral. The bonds in CCP are generally those that are most liquid in the cash and repo markets.

Collateral that is a little more "credit driven" and esoteric is likely to remain within the bilateral arena, where finer details of repo transactions can be negotiated between counterparts on a case by case basis. ATS increases the ability to straight through process repo trades and this is essential in a market with increasing volumes.

MITCHELL: Electronic trading has by far the majority of very short term trades, which are the highest volume, but to date most trades over a week still go direct or through a broker. There is

nothing to suggest that this will change in the near future. The relationship and information flow probably outweighs the reduced cost of using an electronic trading system. Settling trades via a central counterparty not only reduce certain risks but has balance sheet benefits as well.

**5. Is the repo market a good indicator as to the wider leverage activity, or not, in the market?**

ASTANIN: I think that the repo market is a good indicator of leverage activity. It depends on many factors, but definitely illustrates the growth of participant's trading activity and is a good indicator of market recovering

WYLLIE: Since the collapse of Lehman Brothers, banks have cut credit and increased capital ratios resulting in reduced overall repo activity. Globally, with the increased government regulations worldwide, banks have been deleveraging their balance sheets, causing the pronounced contraction in repo markets. As a result, they no longer have the same lending capacity and must focus their efforts on strengthen their liquidity ratios.

BALDWIN: There are many measures of leverage available and repo activity has been used as one such estimation in the past. With money markets distilling towards secured forms, repo volumes should increase in the future. However, these increasing volumes may mean the repo market activity is no longer a viable measure of leverage, especially as rehypothecation and the general efficiency of the market in recycling collateral will create an overstated (due to multiple counting) measure of leverage.

MITCHELL: The repo market is one indicator of leverage activity but there are other ways that leverage can be obtained. Therefore it may be misleading to look at this in isolation. Most banks and broker dealers are being forced to reduce balance sheets and deleverage their trading books. Repo's advantage of being on the whole a very liquid market has perhaps

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  - the settlement depository of the MICEX Group
  - the biggest Russian depository system in terms of assets on deposit
- the only settlement depository servicing all types of domestic securities, which settles 100% of trades on the government bonds market, about 100% of trades on the corporate bonds and munies market, and 99% of transactions with equities traded on the stock exchange market
- the National Numbering Agency for Russia responsible for the assignment of ISINs and CFI codes to Russian financial instruments, and the Substitute Numbering Agency for the CIS countries.



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allowed banks & broker dealers to reduce their repo book size a lot quicker than some other books and therefore show reduced balance sheets.

Levels of leverage have been focused on as an important measure of risk and whilst it shows there is more capital at risk it does not give a true measure of the actual riskiness of the positions.

**6. The share of total business conducted on repo desks that was accounted for by securities lending fell from 21.7% to 12.5%, in just a few months, according to the December 2008 ICMA survey. Do you see the repo market changing in its relationship with securities lending?**

ASTANIN: At the present time the Russian legislation does not recognise securities lending as a market practice. For that reason all trades concerning securities lending and borrowing are based on the repo technologies, since the Russian repo market is well regulated.

In the second half of 2008 we saw huge volumes of repo especially with the Central Bank of the Russian Federation. The reason was cash liquidity, not lending though. Talking about declining securities lending volumes on the whole I suppose that one of the reasons was short-trading bans which regulators put on the markets including the Russian market. The other reasons may be rocketed credit risks of issuers and the deficit of reliable collateral for repos.

WYLLIE: The percentage drop in non-cash security lending activity was also evident in the repurchase markets. Hedge funds continue to deleverage and reduce positions since the credit crunch started in 2007. Overall, banks have tightened and shorten the term structure on which they will conduct business with them. As a result, 15% more hedge funds were liquidated in the first half of 2008 than in 2007 and an entire decade of easy credit are being unwound. Problems surrounding cash based collateral management programmes are now encouraging some securities lending clients to

seriously consider other program like non-cash options that reduce risk. This will nevertheless have an effect on the repo markets with a decrease in requirements for firms.

BALDWIN: The December 2008 ICMA survey followed an extremely volatile period in the market, after the collapse of Lehman Brothers. This period saw some lenders withdraw from the market completely as they re-assessed their lending models. Since then lenders have been returning to the market, albeit with generally tighter collateral and re-investment criteria. Securities lending is an integral part of the repo markets and will continue to be so in the future.

MITCHELL: There are a number of reasons why the securities lending business with repo desks has reduced and it is more that the securities lenders have changed their relationship with the repo market rather than the other way round. Post-Lehman, many lenders reviewed their securities lending programs and in some cases completely pulled out. Those that remained altered their lending and cash reinvestment guidelines to reduce risk. Cash that was raised by lending bonds and reinvested into various short term money market instruments has reduced as focus is now more on the risk of the reinvestment asset.

**7. How do you assess the success of tri-party repo?**

ASTANIN: According to the MICEX Group strategy we are going to offer the tri-party repo service to the market in 2010-2011. We believe there is quite strong market demand for this service.

WYLLIE: Triparty repo is a vital component of financial markets, providing liquidity for both dealers and investors. Last year, investment banks funded up to half their balance sheets through short term repo. The structure of the US overnight repurchase market may have exacerbated the financial turmoil that accompanied the failure of Lehman. The illiquidity in September

was so severe that creditors lost confidence that they could recoup their loans by selling collateral. Those events highlighted that there are certain gaps in the tri-party repo process that need to be addressed and certain levels of risk management that still need to be enhanced. The Federal Reserve is in talks with banks and securities firms about changing how transactions are processed to reduce risks in the over USD5 trillion-a-day repurchase market. The changes include a central clearing system, which is similar to the European model. The flexibility of the European tri-party repo market, which allows users to switch between different types of collateral, helped ease funding strains last year.

BALDWIN: Tri-party volumes took a significant hit post Lehman. The tripartite model is recovering well and has many positive advantages over less automated types of repo. The success of the tri-party repo should be measured in its ability to adapt in the new market conditions and opportunities in collateral markets. This includes the usage of triparty methodologies within CCP models. The signs for the tripartite model in repo are encouraging.

MITCHELL: Tri-party repo has transformed the repo market over the last 10 years. The ability to trade in large size against a pool of collateral would have been operationally very difficult to manage and expensive. Counterparties are able to specify sophisticated collateral parameters to aid risk management and triparty agents offer reporting tools and file downloads to monitor all aspects of the trades. Standardised collateral baskets and the ability to re-use collateral will increase triparty use over the next few years.

In the past there has probably been more focus by the triparty agents on the collateral giver rather than the collateral receiver. This has or is being addressed now with more functionality for collateral takers to specify acceptable collateral in much more detail. ✨