

The European repo market at 2020 year-end

An ICMA European
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(ERCC) briefing note

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Executive summary

- Despite EUR core GC and special rates tightening by the greatest degree in the past three year-ends, the general view is that the turn was relatively subdued.
- Periphery repo rates saw the most acute richening, particularly certain specials, which is largely attributed to the expansion of the ECB's TLTRO operations.
- Participants cite early moves to lock-in financing needs, fewer balance sheet restrictions for dealer banks, and improved accessibility of central bank lending programmes as some of the factors that helped to alleviate any pressures over the turn.
- Sterling rates perhaps saw the most volatility, particularly in specials.
- USD and JPY repo markets were relatively muted over the period.
- From a EUR perspective, looking forward participants are more concerned about collateral scarcity than dealer capacity or excess liquidity.

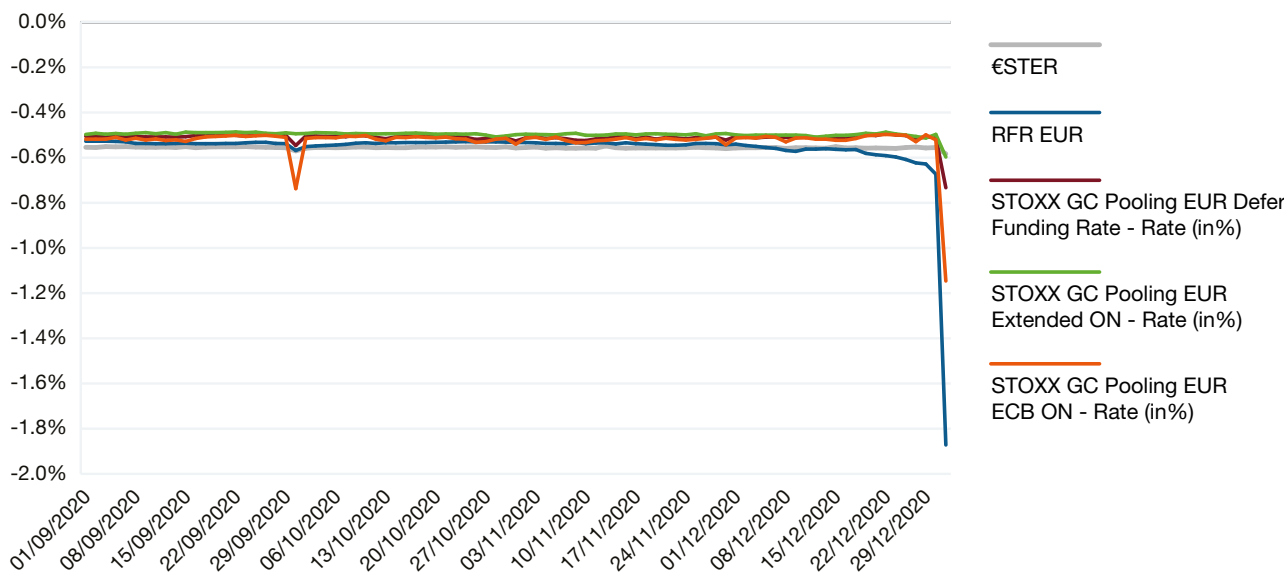
Euro repo

Prelude

Concerns about potential year-end dislocations had begun to build as early as October, and followed the largely unexpected drop in rates at the September quarter-end. Unlike the past relatively uneventful previous three 'turns', market participants were wary of a potential collateral squeeze, citing significant excess reserves (which had increased from €1.7trillion at the end of 2019 to €3.2trillion by the end of October 2020) and a reduced supply of collateral (euro sovereign issuance less central bank

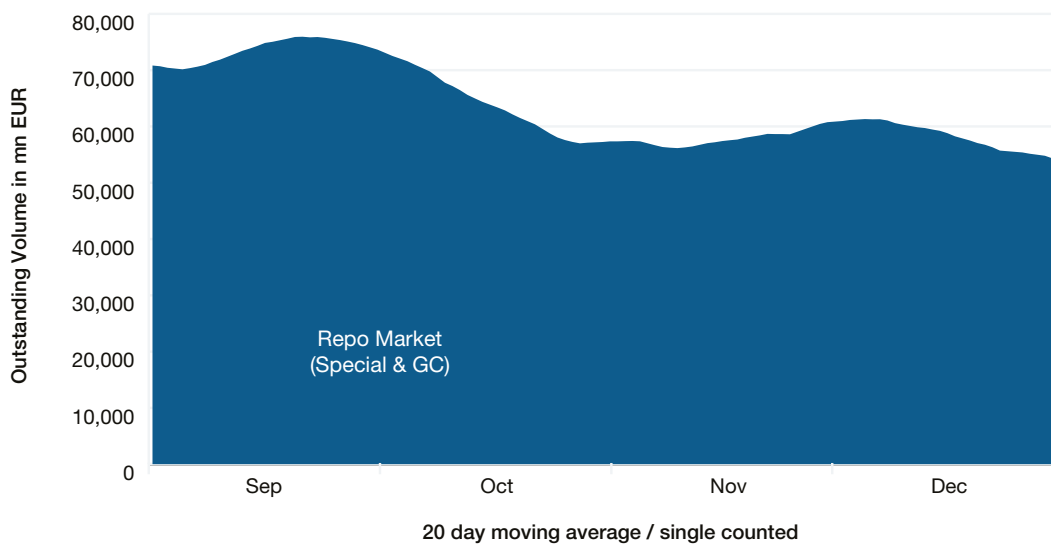
purchases had taken €300billion of collateral out of the market during 2020). A longer than usual (four-day) turn compounded any unease. Meanwhile, the EURUSD cross-currency basis, which had been relatively flat since the extension of USD central bank swap lines following the March-April turbulence, had been steadily moving lower, implying much softer EUR rates over year-end (-5.5% at the start of December). Some participants had begun to fear a year-end similar to that of 2016.

Figure 1: EUR GC repo rates (Eurex)



Source: ICMA analysis using Eurex data

Figure 2: EUR repo outstanding volumes (Eurex)



Source: Eurex

Core

As year-end approached, term rates were implying around -2.6% for German GC and -2% for French GC over the turn. On Dec 29 (two days before the turn), spot-next (S/N) – which is the most liquid trade date for specifics – saw German and French specials being offered around -4% and -3% respectively in the interbank market. However, rates quickly eased as offers chased the bids, and most specifics traded around the -2.5% level. While the spread of specials to GC widened, participants report few instances of particular ISINs coming under particular pressure.

On Dec 30 (one day before the turn), tom-next (T/N) – which is the most liquid trade date for general collateral – saw German and French GC open around -1.8% and -1.75% respectively, and gradually heading tighter over the course of the day to around -2.3% as liquidity thinned. On Dec 31, overnight (O/N) rates averaged around -2% for both German and French GC, with specifics around -2.3%, but volumes were notably light.

Periphery

Heading into year-end, implied Italian and Spanish GC rates for the turn were around -1%. As the date arrived, Italian GC eased slightly from the implied, to trade between -0.85% and -0.75%, with specials trading around -1% to -1.25%. Spain, however, was the surprise market, with GC trading down to -1.25%. Spanish specials became particularly tricky, with several ISINs trading around -2% and some printing as low as -4%.

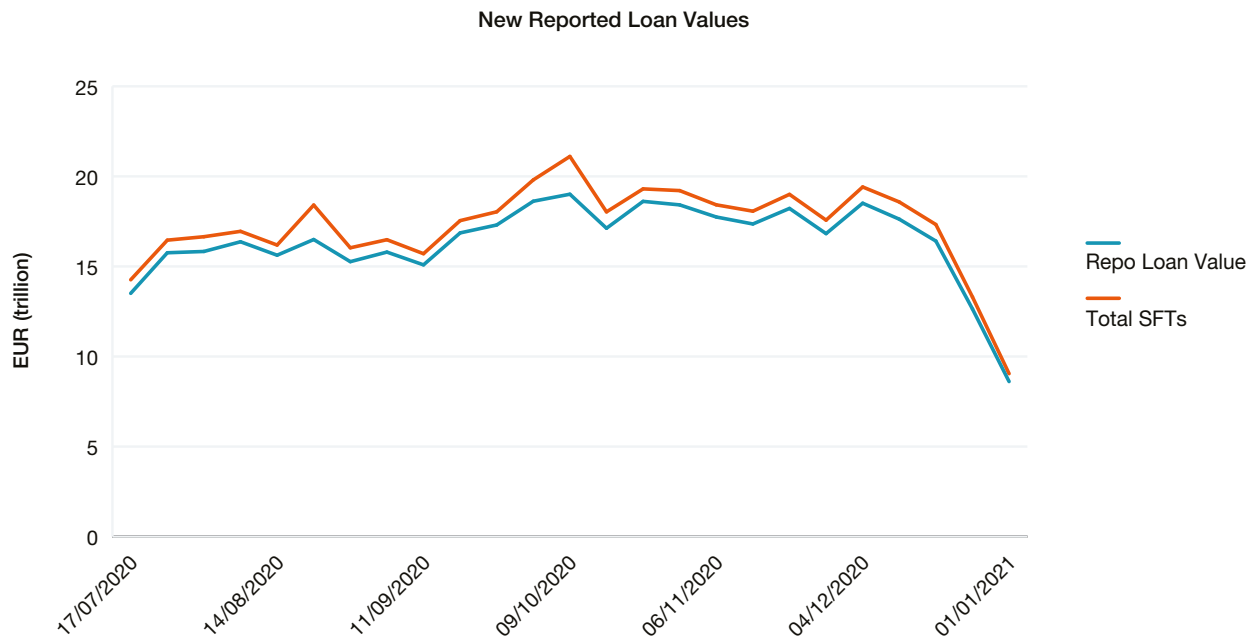
Much of the tightening in Italian and Spanish specials is attributed to collateral scarcity following the recent expansion of the ECB's TLTRO III, which has seen local banks allocating their holdings of domestic government bonds to benefit from the cheap carry.

Explanation

So while repo rates tightened by the greatest degree observed for several year-ends, the overall view was that it was a relatively uneventful and pressure-free turn; particularly in light of its build-up. This is attributed to several factors:

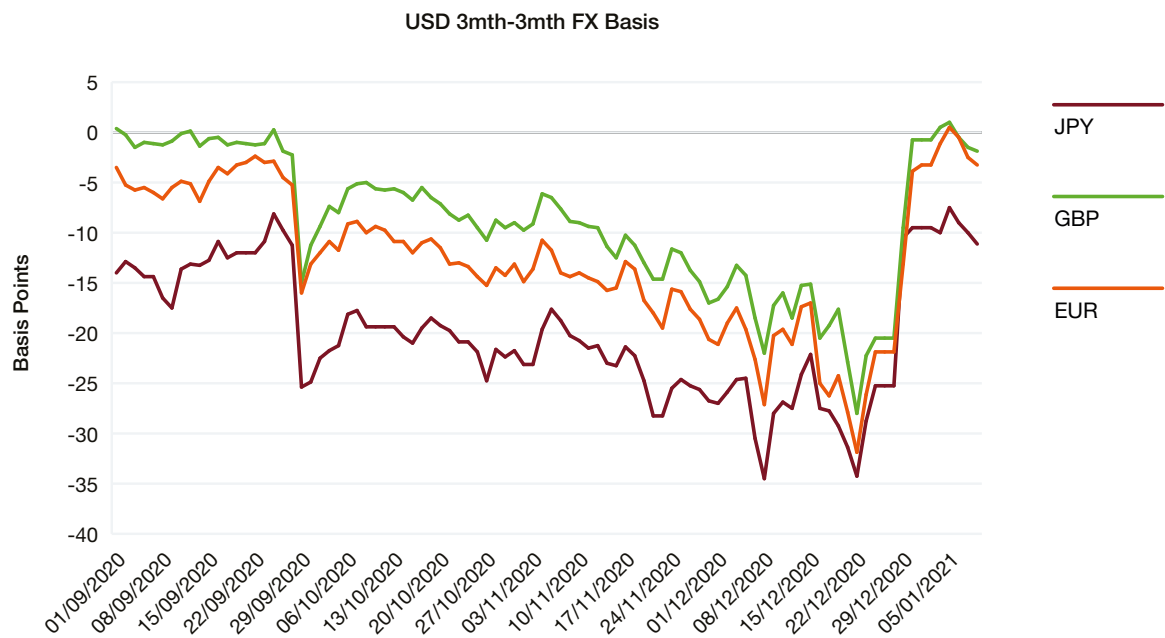
- i. Given growing concerns around collateral scarcity, participants looked to place cash and cover shorts in the term market as early as possible, minimizing their exposure to year-end liquidity pressures. In the case of short covering, much of this was executed on a collateral swap, or 'switch', basis, meaning lenders avoided being left long cash. This can also be seen from the significant drop in trading volumes over year-end (see Figure 3).
- ii. Participants report reduced hedge fund activity from October onward, which again reduced the demand for both leverage and short-covering (as an indicator, the March Bund CTD basis implied repo remained relatively steady around -0.75% throughout the period).
- iii. Dealer balance sheets felt relatively unconstrained, perhaps helped by the temporary relief in the Leverage Ratio calculation. While a rallying US stock market raised concerns that some banks may reduce their repo activity in order to manage their GSIB scores, this did not appear to materialize.
- iv. The currency basis flattened in the final few days before year-end, removing any arbitrage opportunities that would have made EUR collateral cheap for holders of USD (see Figure 4).
- v. The improved accessibility of the ECB lending programmes, along with an easing of the cost of borrowing to a mere 5bp fee, almost certainly helped to provide a pressure valve (see Figure 5). Although central bank lending has generally been more attractive on a collateral switch basis, as we closed in on the year end it was outright lending that took the pressure off GC and specifics and helped to subdue the turn. The easing of the collateral standards by the ECB programmes, such as the acceptance of Additional Credit Claims, also helped to ease the pressure on EGB collateral.
- vi. At the margins, the increased use of sponsored clearing, allowing members' clients access to CCPs, possibly also removed some of the pressure from dealers' balance sheets, although participants note that uptake in Europe is still relatively limited, but gradually increasing.

Figure 3: Reported new SFT activity (EU) - SFTR



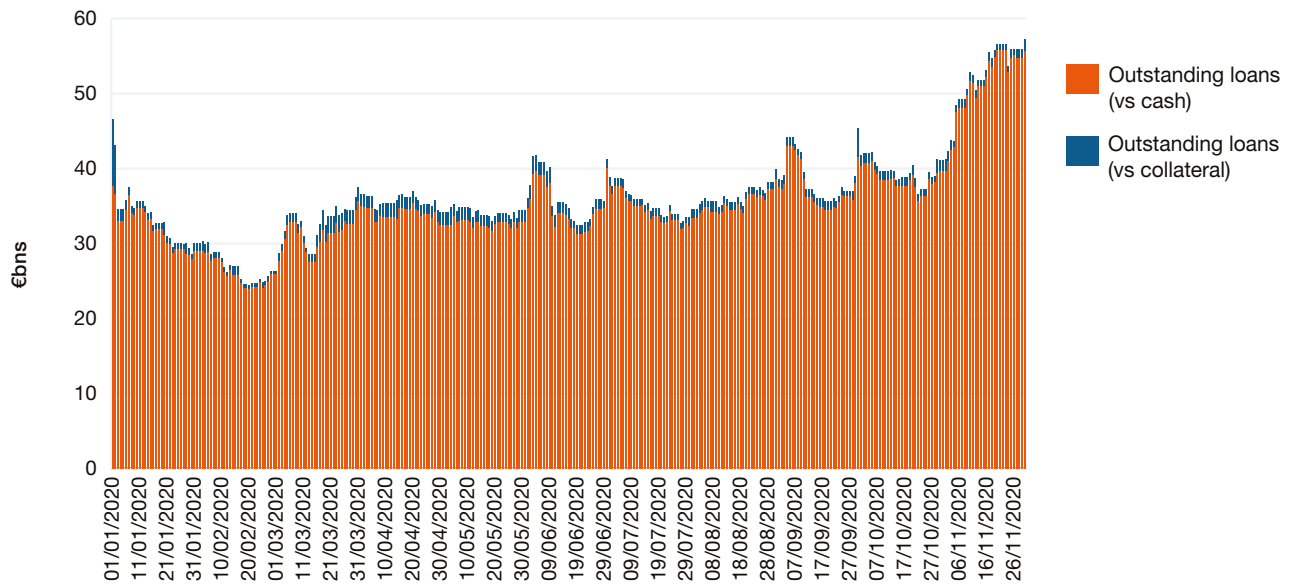
Source: ICMA analysis using public trade repository SFTR data

Figure 4: Currency basis swaps



Source: ICMA analysis using Bloomberg data

Figure 5: PSPP & PEPP lending balances



Source: ICMA analysis using ECB data

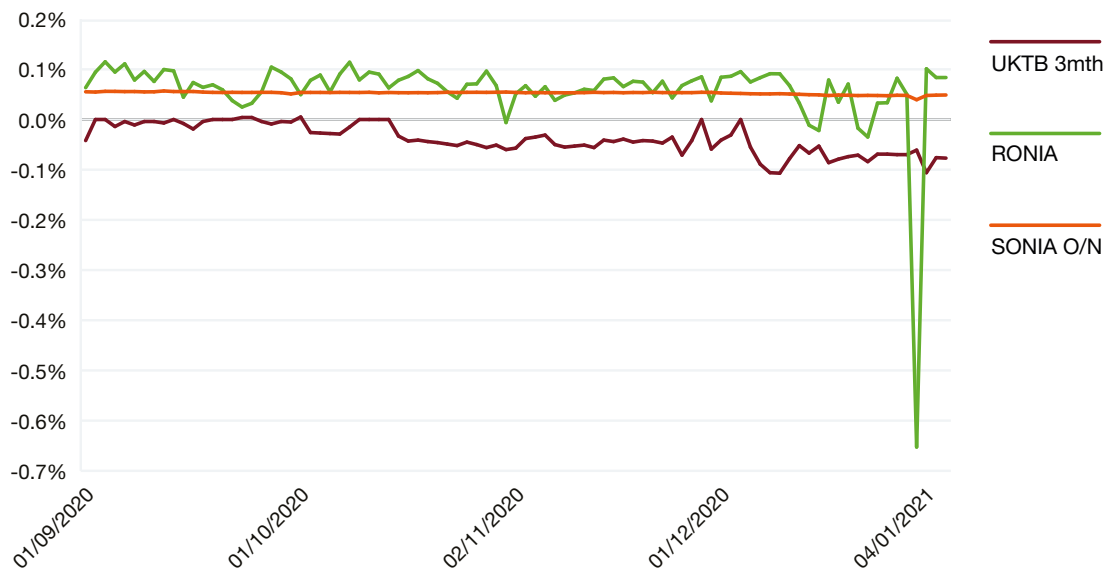
GBP repo

Gilt repo rates were perhaps the most volatile of all the major currencies over year-end. In the week leading up to the turn, O/N DBV¹ rates had been oscillating in a +0.05% to -0.05% range, while term rates implied a year-end rate of -0.25%. A general tightening of short-dated rates since the middle of December is attributed to the supply-demand imbalances, as Gilt issuance ceased, but Bank of England asset purchases continued. A widening of the FX Basis also added to the downward pressure (see Figure 4).

On Dec 29, S/N DBV traded down to -0.20%, and on Dec 30, T/N eased slightly to -0.15%. Then on the final day of the year, O/N DBV tightened aggressively to -0.50%. However, volumes were relatively lower than usual (around £3.5billion compared with a typical daily volume of £9-10billion), with most activity having been executed in advance on the previous day. Specials also came under pressure, particularly sub-10year maturities, which had been heavily targeted in the Bank of England's purchase programme. This saw some ISINs trade as low as -1.00%.

Participants report that as well as ample excess liquidity in the sterling market, putting downward pressure on short-dated repo rates, there has also been a healthy amount of balance sheet capacity for dealer banks, which has not been the case in previous years. This is reflected in an acute flattening of term rates, with a virtual elimination of any term premium, and where LDI (liability driven investment) lenders of collateral have enjoyed a tightening of as much as 40bp compared to previous year-ends.

Figure 6: GBP money market rates



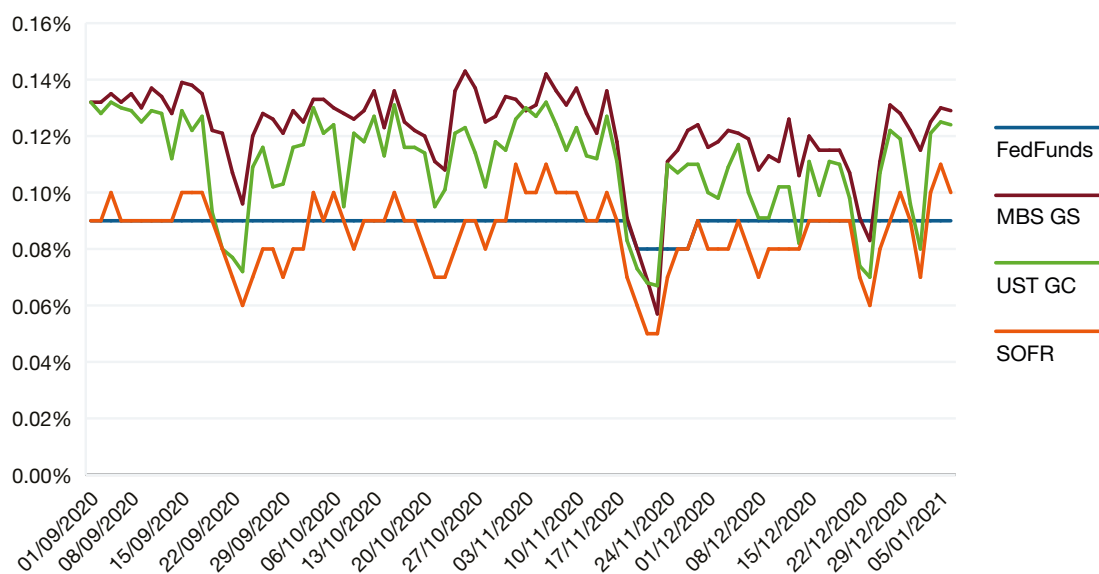
Source: ICMA analysis using Bloomberg data

¹ DBV ("Delivery By Value") repo is a mechanism whereby a Crest/Central Gilts Office (CGO) settlement system member may borrow from or lend funds to another CGO member against overnight gilt collateral. The CGO system automatically selects and delivers securities to a specified aggregate value on the basis of the previous night's CGO reference prices. Givers and takers of collateral can specify the classes of security included in the DBV

USD repo

Given the bounteous amounts of cash being parked at the short-end of the USD market, expectations for any year-end surprises were minimal, with the turn being priced at a relatively modest premium of only a few bps. And so it came to pass, with O/N UST GC averaging 0.11% on Dec 31. The absence of any notable balance sheet pressures (despite the rallying stock market) only helped to ensure a benign end to 2020.

Figure 7: USD repo rates

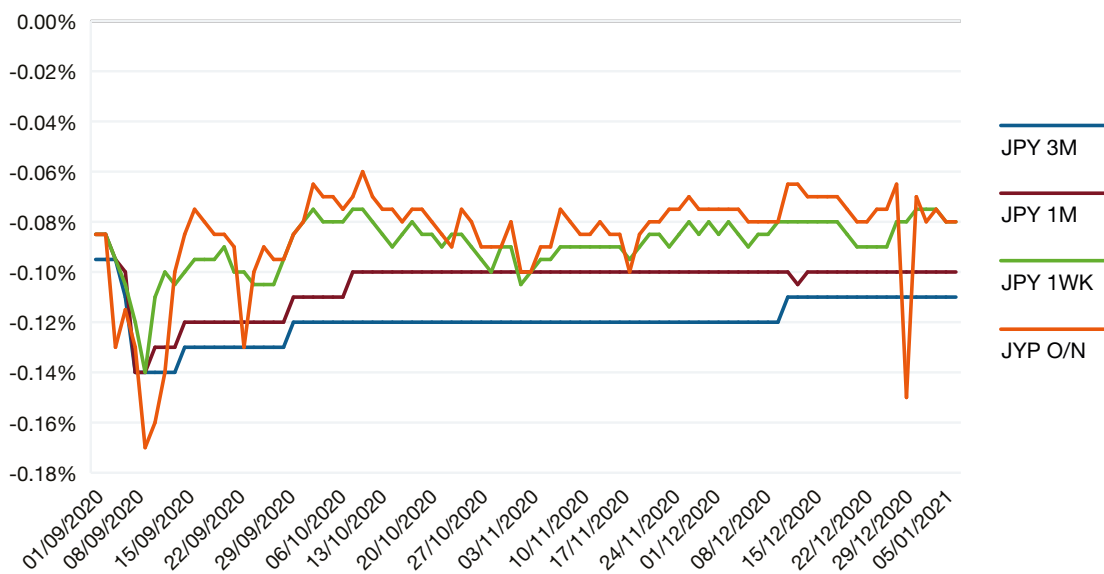


Source: ICMA analysis using Bloomberg data

JPY repo

Leading into year-end, participants were very much focused on the USDJPY basis swap as it moved lower, potentially opening up arbitrage opportunities for USD investors to soak up JPY collateral, driving year-end rates lower. Participants note, however, that a heavy bill issuance schedule helped to bolster the supply of short-dated assets and, along with a sharp flattening of the currency basis, this seems to have ensured a relatively muted year-end.

Figure 8: JPY repo rates



Source: ICMA analysis using Bloomberg data

Conclusion

Most participants appeared relaxed about the 2020 turn, certainly compared to previous year-ends, also noting that the market had done a fairly good job in pricing-in year-end rates in the lead up, particularly for EUR. Many report that buy-sides had looked to execute as much of their funding requirements as early as possible, while the banks went into year-end with more balance sheet than usual to play with. A common concern, however, relates more to conditions over the next twelve months, particularly in the case of the EUR market, given the widening of the PEPP envelope and the prospect of an even smaller EGB collateral pool; more so than the perennial uncertainty related to banks' balance sheets and dealer capacity.

A further consideration for the immediate future is the impact of Brexit on repo market liquidity, as well as for euro denominated derivatives, particularly in light of the migration of the euro equity markets from the UK to the Eurozone on January 4th 2021. The end of the pension fund industry's exemption for mandatory clearing could also increase demand for euro collateral transformation, an issue currently under discussion with the relevant authorities.

The ICMA ERCC will continue to monitor closely market developments, highlighting potential risks and dislocations to the smooth and orderly function of the market. In doing so, it will remain in close contact with the relevant authorities and regulatory bodies.

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