LONDON REPORTING HOUSE

Mandatory CCP-clearing of gilt repo

The Bank of England recently published a staff working paper on The Potential Impact of Broader Central Clearing on Dealer Balance Sheet Capacity: a Case Study of UK Gilt and Gilt Repo Markets (Staff Working Paper No. 1026), which examines whether the balance sheet constraints on dealers could be relieved by comprehensive central-clearing (relaxing access to LCH) and the standardisation of repo maturities (to one day a week). The paper tries to estimate the impact of these measures on the settlement exposure, balance sheet exposure and the Leverage Ratios attributable to the cash gilt and gilt repo activities of the 11 most active GEMMs just prior to and during the Covid-induced 'dash-for-cash' in 2020 (January-February and March, respectively).

A staff working paper is not an official proposal. At most, it is a very preliminary scoping exercise. But it counts as 'sigint' (signal intelligence). We can listen to the chatter about wider central-clearing swell and possibly culminate in a regulatory mandate.

Wider central-clearing is certainly on the regulatory agenda. In September 2022, the Securities and Exchange Commission (SEC) proposed rule changes to mandate the clearing of US Treasury securities and repo as part of a suite of reforms being considered to increase market resilience. There are parallels between gilts and Treasuries (too many government bonds and not enough government bond dealers). At the international level, the Financial Stability Board (FSB) has recently recommended that national authorities should explore ways to increase the availability and use of central-clearing in government bond cash and repo markets as a way of enhancing market resilience.

The study

The Bank paper shows that the **nettable stock of gilt repo** transacted but not cleared at a CCP by their sample of 11 GEMMS increased from 30% of total uncleared repo in 2017 to some 40% in H1 2022, while the stock of centrally-cleared repos grew from 25% to 35%.[1] [2]

The estimated impact of **comprehensive central-clearing** was a potential increase in the stock of nettable repo by 17% to the equivalent of about 10% of the total stock of gilt repo. That increase would itself have been equivalent to some GBP 66 billion in January-February 2022 and GBP 82 billion during the 'dash-for-cash' in March. About 45% of the increase would have been equally in interdealer repos and repos with hedge funds.[3]

Most of the opportunities for comprehensive central-clearing would have been in short dates and, not just in interdealer transactions, but also in dealer-customer repos with money market funds, hedge funds, sovereign wealth funds and corporates. There was very little netting potential beyond six months and involving institutions such as pension funds.

Standardised maturity dates would have increased the potential share of nettable repos by the equivalent of another 14% of the total stock of nettable repo, equivalent to about GBP 40 billion both prior to and during the 'dash-for-cash'.

Comprehensive netting would have been able to reduce the **gross settlement obligations** of the sample of 11 GEMMs by 48% in January-February 2022 and by 53% in March. It is suggested that more central-

[1] UK SFTR data put central-clearing in H1 2022 somewhat lower at 18.9% of end-semester balances. However, UK SFTR measures repos in all currencies and the UK SFTR sample is larger than the SMMD sample. On the other hand, SMMD is claimed to cover some 95% of the gilt repo market. In addition, CCPs report under UK SFTR but not under SMMD. The implication is that GEMMs are more intensive users of central-clearing than the repo market as a whole (the paper notes that the interdealer segment of the gilt repo market is almost entirely centrally-cleared).

[2] Another interesting statistic was that 70% of centrally-cleared repos could be netted.

[3] It is interesting to note that gilt repo market expanded by about 10% during the 'dash-for-cash', that is, about GBP 66 billion. During the LDI crisis in autumn 2022, LDI investors cut their net repo positions between 22 September 2022 and the end of the Bank of England intervention on 14 October by about GBP 25 billion or (12%) and also sold off some GBP 37 billion of gilts. The estimated effect of comprehensive central-clearing was to increase the stock of nettable repo by 17%, equivalent to GBP 75 billion before the dash-for-cash and GBP 81 billion during that episode. The extra netting capacity therefore looks as it could have made a significant difference, particularly during the dash-for-cash, given that this was concentrated in more readily nettable short tenors. However, during the LDI crisis, the gilt repo market was hit by outflows of collateral from pension funds, who were already net borrowers and concentrated in long-dated gilts (50%) and index-linked gilts (70%), for which there is anyway a smaller market in repo.

clearing would probably also have reduced **settlement fails** (given that these rose from about 2% of all gilt repo in January-February 2022 to 6-7% in March while peaking at only 2% in centrally-cleared repos).

The potential impact of comprehensive central-clearing on the **Leverage Ratios** of a subset of six GEMMs was a reduction in the contribution of gilt repos from 0.09-0.10 percentage points to about 0.06 percentage points in January-February 2022 and by the same amount during the 'dash-for-cash'. Standardised maturity dates would have achieved a further reduction to almost 0.04 percentage points. The paper admits that these changes are small compared with both Leverage Ratio levels (minimum 3%) and the headroom available to dealers (about 1.90% on average across the 11 GEMMs in the wider sample) but argues that it would be more significant when considered at the level of the repo desk. On the other hand, the paper recognises that banks might not actually use the Leverage Ratio capacity released by comprehensive central-clearing and standardised maturity dates to expand their gilt repo intermediation activities.

The paper speculates that, in addition to comprehensive central-clearing and standardised maturity dates, constraints on dealers' intermediation capacity could also be relieved by facilitating more **'all-to-all' trading**.

Subsidiary benefits of comprehensive clearing

The paper accepts that the study is partial and does not lay out the full range of pros and cons, and that any net benefit will also depend on how any proposals are implemented. Some of the other considerations suggested are summarised in the table.

pros	cons
• Enhanced dealer intermediation capacity	• Other constraints on dealer intermediation capacity (e.g. internal risk limits) may stops netting benefits from being used • Balance sheet savings on repo might be diverted to other business lines
• Reduction of gross settlement obligations and fails • Improved operational efficiency	• Relaxation of membership criteria might degrade the counterparty credit risk exposure of CCPs • Standardised maturity dates would increase liquidity risks for CCPs • Increased operational demands on CCPs of expanded membership
• Reduction in counterparty credit risk for market participants • Reduction in contagion risk for the wider system • Reduction in risk barriers to 'all-to-all' trading	• Increased CCP membership would translate into increased margining requirements and increased systemic liquidity risk • Market liquidity risk would be further heightened by the CCP requirement for variation margin to be paid in cash variation margin, whereas bilateral margining allows for securities to be given as margin
• Standardised and potentially more robust risk management standards and contract terms	• Concentration risk among client-clearing sponsors
• Diversifying buy-side routes to market, including 'all-to-all' trading, reducing reliance on dealer intermediation	• Regulatory requirements on dealers acting as client-clearing sponsors will offset some of the balance sheet gains of wider netting • All-to-all trading could reduce the value of dealer franchises and reduce intermediation capacity
	• Cost of joining a CCP • Ongoing cost of central-clearing • Limits on money market fund exposures to a single counterparty, even a CCP

Some comments

The paper rather looks as though it has tried to set up current market practice as a straw man to be knocked down by estimates of untapped netting potential. In reality, it is likely that much of the estimated netting potential will already have been tapped, albeit through bilateral netting under the terms of the legal agreements between parties. Of course, bilateral netting is not as efficient as multilateral netting across a CCP. Perhaps, therefore, the study should have estimated how much more netting could have been achieved by comprehensive central-clearing and standardised maturity dates. That may not be much. Dealers would not want to leave much balance sheet capacity on the table. We know that a lot of attention is being paid in the market to devices such as netting packages and collateral swaps.

However, while bilateral netting will reduce counterparty credit risk and balance sheets, it is unclear how much of that netting gain could be translated into a reduced Leverage Ratio. The rules on recognition of bilateral netting in the Leverage Ratio are much stricter than for central-clearing.

Estimating the impact of standardised maturity dates is likely to be a waste of time, even as an illustrative exercise. Although dealers do already trade repos against collateral that is deliverable into futures to the 20th of the delivery months and break long-term repo over end-year month to maximise netting opportunities, the further standardisation of maturity dates looks impracticable, not least because of the prevalence of one-day repo.

On the other hand, more comprehensive central-clearing is a possibility, albeit only through client-clearing schemes such as sponsored repo. The application of indemnification to some of these schemes has widened indirect access to hedge funds (in Europe, Eurex has done this and LCH is about to follow; it has always been possible in Sponsored Repo in the US). But sponsored repo has so far struggled in Europe and full membership is not going to happen for hedge funds, money market funds and corporates (outside of the NCC in Russia, about which it's worth reading a paper by Dmitry Chebotarev which investigates one of the consequences of open membership).

However, comprehensive central-clearing and standardised maturity dates do not seem to have such dramatic impacts on Leverage Ratios as to make their introduction an overwhelmingly obvious solution to the shrinkage in intermediation capacity.

The idea of encouraging 'all-to-all' trading is a can of worms. For example, in the next 'dash-for-cash', all that demand for liquidity would flood back to the dealer market, which may well have shrunk because capacity has been sapped by the diversion of demand into the all-to-all market during the good times. May I coin the term 'unintended pro-cyclicality'?

Where did the data come from?

The data for this paper came from MiFID for the cash gilt market and the Bank's Sterling Money Market Daily (SMMD) reporting regime for gilt repo. The Bank chose to utilise their own SMMD data for the purposes of this report however we have received indication that they are increasingly turning their focus to SFTR and plan to share their findings in the near future. It is also worth noting that the Bank of England is the National Competent Authority for UK CSD and CCP SFTR Reporting.

******

About the Author

This paper was written by Richard Comotto, Co-founder and Chief Product Officer, London Reporting House.

Richard has been involved with repo for over 20 years and is a well-known figure in the market. During that time, he has been an adviser to the ICMA's European Repo and Collateral Council (ERCC), among other things, conducting its authoritative semi-annual survey of the European repo market since 2001 and authoring its Guide to Best Practice in the European Repo Market, which is the most comprehensive code of conduct in the financial markets.

His Repo FAQs page on the ICMA website is its most actively consulted published resource on repo. More recently, Richard has supported the ERCC's SFTR Task Force and authors its authoritative Recommendations for Reporting Repos under SFTR and other guidance. Richard is ICMA's Director of Education on repo and has trained many of those currently working in the European repo market (including staff at the ECB and FRBNY). He has also been retained by the IMF, World Bank, Asian Development Bank and market development foundation, Frontclear, to advise on the creation of new repo markets in Central and Eastern Europe, Africa, Asia and South America.