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

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

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
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 additional resources 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 notional
  - 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