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COLLATERAL IS THE NEW CASH: THE SYSTEMIC RISKS OF INHIBITING COLLATERAL FLUIDITY

A presentation for

EFMLG

Frankfurt

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Overview

- Collateral is the new cash
- Collateral demand, supply, and equilibrium
- Collateral fluidity (the ‘plumbing’ and the ‘pump’)
- Factors that may enhance or inhibit collateral fluidity
- The systemic risks of inhibiting collateral fluidity
- The coupling of regulation and collateral

Collateral is the new cash

- Collateral is becoming increasingly important in the post-crisis world, driven by both a need for more secured funding as well as regulatory requirements to reduce credit risk. In many ways, collateral has become the new cash, underpinning the smooth functioning of funding and capital markets that reduces risk, and, in turn, provides the basis for economic growth.

- Uses:
  - Securitizing loans
  - Collateralizing repo transactions (including central bank money market operations)
  - Margining OTC derivatives trades

Collateral Demand

The increased demand for collateral stems from three main sources:

- The continued move from unsecured to secured funding driven by new risk evaluation models, capital treatment, and deleveraging
- Basel III (CRR/CRD IV) liquidity requirements
- Margin requirements for cleared and un-cleared OTC derivatives trades

Demand *collateral*

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Estimates of incremental collateral requirements for OTC centralized clearing

Organization	Incremental Collateral Required	High-Level Description of the Basis for the Incremental Collateral Requirement Estimate
IMF	$100bn-$200bn	The shift to CCPs will elevate collateral demand for Initial Margin (IM) and guaranteed funds
Bank of England	$130bn-$450bn	The IM required for IRS/CDS under normal market conditions, assuming no change in the gross notional volumes and 80% of trades being subject to central clearing
BIS	$720bn	IM required for dealers and non-dealers where all clearing for IRS/CDS takes place at only one CCP for each product (to reduce negative impact on netting).
Oliver Wyman / Morgan Stanley	$750bn by 2015 $1.4tn by 2018	A combination of increased requirements in IM in the near term for centrally cleared transactions and IA in the longer term for non-cleared transactions The increase will also be driven by the inability of firms to net across regions/CCPs
US Treasury	$800bn-$2tn	Quantum of new IM and stringent eligible collateral requirements will greatly increase the demand for high-quality collateral

Source: Barclays, 2014, 'Much Ado about Collateral: Recent Changes in the Regulatory landscape for OTC Derivatives and the Potential Impact on Collateral'

Collateral Supply

- The CGFS estimates that the total increase in AAA/AA government securities between 2007 and 2011 was $7.7tn. This goes up to $11.3tn when short-term government securities, corporate bonds rated A or better, and US securitized bonds are included

- Difference between aggregate supply and effective supply
  - Much of this collateral may effectively be silo-ed
  - Different eligibility criteria across financial centres and jurisdictions could also lead to localized shortages.

  - Dislocations could be corrected by:
    - Price adjustment
    - Other exogenous supply factors

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Collateral Supply

- Government and non-financial corporate issuance
- Securitization of assets
- Broader eligibility of HQA

Effective Supply *collateral*

- Quantitative easing
- Foreign exchange reserve management

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Collateral Equilibrium

Demand *collateral* ≡ Effective Supply *collateral* x Collateral Fluidity

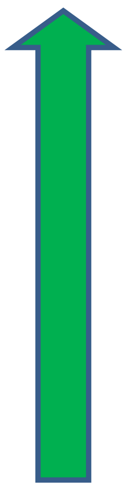
Adapted from collateral equilibrium equation of Manmohan Singh

Collateral Fluidity: The Plumbing

Fluidity *Plumbing*

- Limited operating hours of CSD settlement links in central bank money (CeBM)
- Lack of flexibility in the cross-border settlement arrangements in commercial bank money (CoBM)
- Ineffective tri-party settlement interoperability
- Lack of cross-border standardization for end-of-day treasury adjustments in CeBM

Collateral Fluidity: The Plumbing



Fluidity *Plumbing*

- Target2-Securities (T2S): standardizing cross-border settlement in terms of cost, technical processing, and efficiency, and creating a centralized delivery-versus-payment settlement system for the pan-European market
- EU Central Securities Depository Regulation (CSDR): harmonizing settlement periods, trade recording, and conduct of business and prudential requirements across all CSDS, CCPs, and trading venues
- Tri-party settlement interoperability between ICSDs/CSDs

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Collateral Fluidity: The Pump

The integrated bank funding function

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Collateral Fluidity: The Pump

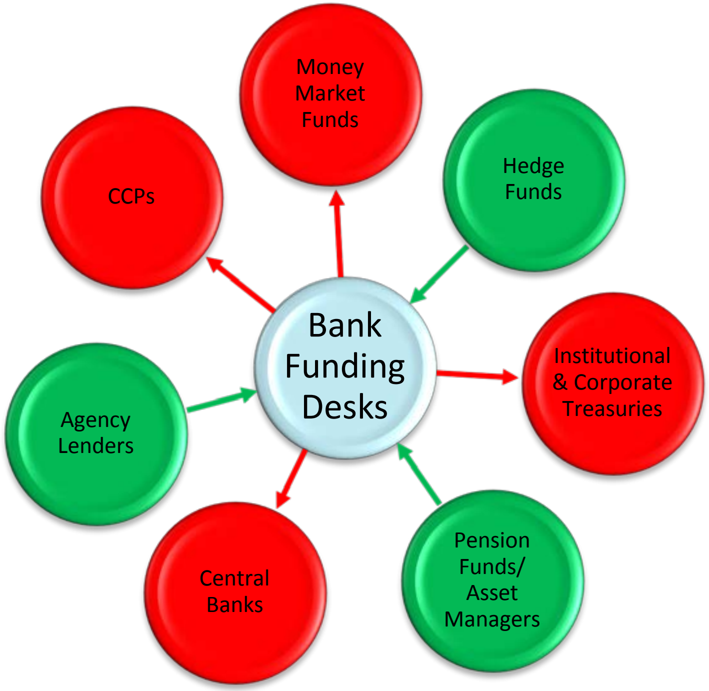
Bank funding desks can serve a number of crucial functions:

- Funding the trading positions (longs and shorts) of the bank, which supports the market making function (and so liquidity) in bonds, equities, and related securities and derivatives
- Interfacing with the central bank in money market operations as part of bank liquidity management
- Managing the bank's liquidity buffers and stock of high quality liquid assets
- Collateral transformation: the substitution via repo of unusable collateral for sourced usable collateral
- Providing liquidity and pricing to the bank's diverse client base for their various short-term funding and investment needs

Fluidity *Pump*

Collateral Fluidity: The Pump

The market-making service of the bank funding desk



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Factors that may enhance or inhibit collateral fluidity

- Basel III Leverage Ratio

  Primary constraint on much SFT activity

- Basel III Net Stable Funding Ratio

  Asymmetry of treatment of SFTs with non-bank counterparties

- Mandatory haircuts for SFTs

  Increased cost and lower liquidity

- Mandatory clearing for SFTs

  Over -concentration of risk in CCPs and

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Factors that may enhance or inhibit collateral fluidity

- Mandatory buy-ins and penalties
  Best way to enhance liquidity?
- Asset encumbrance measures
  When do SFTs encumber assets, and when do they not?
- Reporting of SFTs
  Useful or challenging?
- Central bank interventions
  SLS/CLF

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Factors that may enhance or inhibit collateral fluidity

- Shadow banking
  Enhancing liquidity or increasing risks
- Financial Transaction Tax
  An existential risk to funding and capital markets
- Collateral management
  The new challenge for bank funding desks

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The systemic risks of inhibiting collateral fluidity

Collateral disequilibrium under stressed market conditions

- Secured funding
- Liquidity buffers
- Margin

- CB liquidity measures

Demand *collateral* ≠ Effective Supply *collateral* x Collateral Fluidity

- Credit concerns
- Reduced eligibility

- No liquidity in SFTs
- Disincentives to lend
- Restricted collateral re-use
- CCP costs / security restrictions
- Fragmented settlement systems

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The systemic risks of inhibiting collateral fluidity

Collateral equilibrium under stressed market conditions

- Secured funding
- Liquidity buffers
- Margin

- CB liquidity measures

- Liquid SFT market
- Incentives to lend
- Prudent collateral re-use
- Option to trade SFTs bilaterally
- Harmonized settlements systems

Demand *collateral* ≡ **Effective Supply *collateral*** x **Collateral Fluidity**

- Credit concerns
- Reduced eligibility

The impact of inhibiting collateral fluidity

For the markets:

- Less liquid secondary markets for securities
- Greater asset price volatility
- Hedging, and the pricing and management of risk, becomes more difficult
- Greater execution risks for investors

For the economy:

- Reduced investment in capital and businesses
- Higher borrowing costs for governments
- Increased costs for corporate and non-government capital raisers
- Increased cliff-effect risks for pension and other institutional investment funds
- More onus on central banks to support the markets
- Dampening effects on GDP and economic growth
- Increased systemic risks to the financial system that will be crystallized under conditions of market stress

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Conclusion: the coupling of regulation and collateral

- There exist a number of market and regulatory initiatives that may impact collateral fluidity, either positively or negatively. Some relate directly to the ability of bank funding desks to function effectively, while others affect the providers and takers of collateral.

- The systemic risks arising out of regulation that inhibit collateral fluidity would have broad and severe repercussions, not only for the financial markets, but throughout the real economy.

- Sound regulation is essential for the efficient and stable functioning of global funding and capital markets that support our economies. These markets are already significantly safer than before the financial crisis. As collateral becomes an increasingly important feature of the new market and regulatory landscape, so regulation should avoid inhibiting, and ideally seek to enhance, collateral fluidity.

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