BANK OF ENGLAND

Speech

Why there is life after death: four myths about the future of securities financing markets

Speech given by

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It is a great pleasure to be with you here today.

Reading the title of this speech, you might worry that I am about to launch into a badly misjudged religious sermon. I can reassure you there is no risk of that. There is however often a distinct air of fundamentalism when it comes to discussions on securities financing markets – both amongst those commentators who accuse them of single-handedly causing the financial crisis, and amongst those in the industry who abhor the post-crisis regulatory response as crude and heavy handed. Of course, neither of these extremes is correct. A regulatory response to the crisis was needed. But the medium-term future for securities financing markets is not, I believe, a bleak one – no matter how it may seem today. In fact, repo and securities lending are set to play an absolutely central role in the post-reform landscape. That landscape however will be different from the one we knew pre-crisis, with different players, different business models and different systems and infrastructure. The challenge is to work out what that landscape will look like, and how to begin adjusting towards it.

The Bank of England cannot afford to be, and is not, a bystander in this debate. The Bank relies on healthy, well-functioning repo markets to implement monetary policy, and to transmit that policy to the wider economy. The Bank is responsible, through its new Financial Policy Committee and more broadly through its membership of international bodies including the Financial Stability Board (FSB), for protecting and enhancing the resilience of the financial system as a whole. That means both seeking out and tackling any system-wide vulnerabilities that emerge in securities financing markets, but also ensuring that such interventions do not unnecessarily impede growth and prosperity. And, through the PRA, the prudential supervisor, the Bank is responsible for ensuring that banks, insurers and large securities firms comply with Basel 3 and other internationally-agreed rules.

The Bank cannot perform these challenging roles without a close understanding of the markets themselves. It was with that in mind that we set up the Securities Lending and Repo Committee in the 1990s to bring together senior market participants, infrastructure providers and regulators. The Committee, which meets quarterly under my chairmanship, remains in fine health – and both its discussions, and the relationships it has fostered, have provided a vital sounding board for both our market operational and regulatory thinking.

To draw out why I am optimistic about the future, I want to frame my remarks today around four quite commonly-heard, but I believe mythical, concerns.

Myth 1: regulators and central banks want to kill off repo and securities lending

The first myth is that regulators have been engaged in a determined attempt since the financial crisis to kill off the securities financing markets altogether. I am not going to pretend the breadth of regulatory change facing the industry is modest – the list of new requirements is long, from the capital, liquidity and leverage provisions of Basel 3, to the cleared and non-cleared margin requirements of EMIR, and the prospective norms for haircuts emerging from the Financial Stability Board. It will be some years before anyone will be able to calculate with certainty whether the calibration of all these changes, taken together, has been set appropriately. But no-one can seriously dispute the hard fact that key risks were under-priced in the pre-crisis era – whether through excessively cheap access to dealers' balance sheets, risk-insensitive haircuts, infrequent revaluation and margining procedures, extensive but opaque rehypothecation chains, or uncertain default procedures. The combination of excessive leverage and opacity proved toxic, both for the markets themselves, and for the wider system.

Painful as the adjustment process has been, the crisis and the reforms that followed it will, I believe, leave the markets in a more sustainable place – both in terms of firms' own risk management, and in terms of regulatory backstops. Indeed, it is important that that prediction comes to pass – because secured financing markets are crucial to the financial system of tomorrow. Providing collateral to protect against counterparty risk; to meet regulatory requirements and to bring to central banks; and to support market-based sources of credit to the real economy. Indeed I don't think Manmohan Singh and Peter Stella overstate it when they describe the collateral system as the 'modern money creation process' – lubricating every part of the financial world. Central banks' own balance sheets can play a part in that process too – not by taking the place of collateral markets, but by providing a credible and predictable backstop at times of stress. That was one of the key driving principles behind the extensive reforms to the Bank of England's Sterling Monetary Framework announced by our Governor last October[1]. So, far from trying to kill the securities financing markets, central banks need them to thrive – but in a safer and more reliable way than they did pre-crisis.

Myth 2: there will be a global 'collateral crunch'

The second myth, which ironically sometimes follows hot on the heels of the suggestion that collateral markets will cease working altogether, is that the increase in demand for high-quality liquid collateral to meet new regulatory requirements will be so large it will exhaust the available supply, causing a global 'collateral crunch'.

The facts for this claim don't bear close scrutiny. The most comprehensive study so far, drawn up by the Bank for International Settlements (BIS)[2], suggests that liquidity regulation and OTC margin requirements might ultimately boost demand for high-quality collateral by some $4 trillion over several years. That figure, though huge in absolute terms, is <u>much</u> smaller than measures of global supply. The supply of AAA- and AA- rated government bonds, for example, has risen by over $11 trillion since 2007; the stock of non-cash collateral eligible for derivatives transactions is some $50 trillion; and the major central banks have transformed more than $4 trillion of collateral (some high quality, some less so) into the most liquid asset of all – central bank reserves – through their quantitative easing programmes.

[1] http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf
[2] 'Asset encumbrance, financial reform and the demand for collateral assets', BIS, May 2013: http://www.bis.org/publ/cgfs49.htm

On the face of it, that's not much of a crunch.

But those predicting a crunch argue that the *effective* supply is much smaller than suggested by these numbers because of rigidities in the mechanisms for getting collateral from those who have it to those who need it. On this view, even if a global crunch is far-fetched, localised ones (for particular asset classes, markets or jurisdictions) may not be.

There certainly are some important limits to so-called 'collateral fluidity'. A good share of securities collateral is in the hands of funds who don't want to lend, or cannot (eg because of UCITS restrictions). Central bank reserves can only help to meet cash collateral needs of non-banks if banks choose to on-lend it in the form of repo. Securities collateral can get 'locked up' in entities such as CCPs or central banks who do not on-lend, for good reason. Large firms sometimes struggle to mobilise their own collateral across internal business lines. And there are other operational rigidities posed by systems barriers or national borders.

These are real issues. But it is hard to evaluate their quantitative significance without much better data on the sources of demand and supply in the system as a whole. Those data have proved hard to assemble, reflecting in part the relatively low level of transparency in securities financing markets. When we at the Bank speak with market participants, however – as we do very regularly – very few contacts yet report signs of an impending crunch in their markets. Maybe the scale of the challenge has simply been exaggerated. More plausibly, the extent of any crunch – local or global – will only really become clear when the transitional timetables and grandfathering arrangements for the new regulatory requirements have been worked through, and financial market activity returns to more normal levels.

If all of this suggests that it does make sense to tackle obstacles to collateral fluidity over time, the next question is who should do it? That takes me to my third myth…

Myth 3: barriers to collateral fluidity are primarily for the public authorities to remove

Some in the markets will inevitably look to the public authorities to lead. And we certainly must do what we can in areas within our control, both domestically and working in international partnership. The Bank of England has, for example, taken big steps to extend the range of collateral eligible for our lending facilities. In removing barriers however, it will be important not to discard firebreaks explicitly designed to protect financial stability or investors' rights. That is relevant, for example, in the debate about limits on collateral rehypothecation. Unwinding central banks' massive crisis-era intermediation across their own balance sheets may also be desired by some. But that can only happen on a timetable dictated by monetary policy considerations.

Against that backdrop, it must be the case that most of the solutions to improving collateral fluidity – and certainly the best ones – will come from the market. Market solutions of course require investment, and investment requires an expectation of making a decent return. I recognise that such returns may be relatively few and far between in current market conditions. But I don't believe that means the price mechanism will never work. As and when a more substantial imbalance between demand and supply of collateral does develop, as monetary policy normalizes and financial market activity recovers, that will be reflected in a rising price of the relevant collateral. And that in turn will induce in greater collateral supply, and more investment and innovation in private sector solutions to collateral fluidity.

If such economic incentives are for the future, regulatory incentives to innovate are here now. The prospect of beneficial capital treatment and freeing up scarce balance sheet, has increasingly driven sell-side firms to look for ways to improve their tools for locating the right collateral, at the cheapest price: so-called 'collateral optimization'.

This optimization can happen both within firms, and between firms. Within most large firms, on both the sell- and the buy-side, there is significant scope to draw together previously balkanized collateral silos across product lines, national borders and clearing and settlement systems. The barriers to doing this, both cultural and technological, can however be daunting, and I think it is fair to say that firms differ quite widely in how far they have travelled down this road[3]. I have certainly seen some impressive examples of in-house systems allowing firms to identify, price and allocate collateral right across their business. Indeed, done optimally, collateral management becomes indistinguishable from the sort of trading and balance sheet optimization that has traditionally been the exclusive preserve of the front office. But the lesson I also take away from these examples is that what really unlocks success is not expensive front-end screens or trading aids, but a relentless focus on getting the basics right – locating the collateral across all of the firm's systems, categorizing it according to its risk characteristics, and giving clear control rights to those at the centre. These things are easy to say – but harder to do.

Where firms cannot locate the collateral they need internally, they will have to look externally – to the so-called 'collateral upgrade trade', in which collateral demanders exchange lower-grade assets for the higher-grade collateral they need, for a fee. Both the authorities and market practitioners have been eagerly seeking information about the scale and nature of these trades for some time. Even identifying them has been hampered by the fact that in truth they are really just variants of standard securities lending or repo trading. But it is clear that the relative lack of system leverage and the slow introduction of new collateral requirements mean that growth in this business has been more of a gentle upward curve than the explosion that some once forecast. It is also somewhat different in kind. For example, it is not uncommon to find large buy side firms, who one might have thought would be potentially large <u>suppliers</u> of high-quality <u>securities</u> collateral, constrained from doing so by their mandates or regulation, but instead being large net <u>demanders</u> of <u>cash</u> collateral to meet clearing margins. Regulators have more to do to understand the nature and scale of these flows.

[3] For example, and with some notable exceptions, there seems so far to have been much less innovation amongst firms on the buy side.

If collateral optimization in all its forms can bring real benefits, it also poses some challenges, both to firms and to the system as a whole. First, the more frequent 'churn' in collateral positions, as firms re-optimise, poses operational risks ('pedalling ever faster to stand still' as one of our contacts recently put it). Second, optimization is likely to lead to lower buffers of excess collateral, increasing liquidity risk. Third, concentration risk could also rise if everyone's cheapest to deliver algorithms start to identify similar assets. And, fourth, more aggressive collateral transformation increases the risks that those accepting a collateral downgrade may not fully understand the extra risks they have taken on. A central bank group co-ordinated by the BIS has been examining these issues, and will report later this year.

Myth 4: there's no way to make an economic return on securities financing business

That takes me to my fourth and final myth: that there's no way to make an economic return on securities financing. I suspect this may be by some distance the hardest of the four to tackle with this audience – so let me be clear first what I am <u>not</u> arguing.

I am not arguing that the balance sheet costs associated with traditional business models have not risen as the result of regulatory change. In some cases sharply. In some cases, frankly, by design.

Nor am I arguing that securities financing is currently a high-, or even a medium-return business.

But I nevertheless do believe that there are grounds for optimism about the medium-term prospects for securities financing. Demand <u>will</u> recover; and when it does, returns will rise. Those returns will in turn incentivise greater collateral supply and higher investment. But they will also incentivise innovation – and that I think is the most important message of all: the securities financing markets of the future will not look like the securities financing markets of the past, in terms of its players or its infrastructure. Change, perhaps quite radical change, is inevitable. All of us have a stake in understanding how that new market will look.

Let me say a little more on each of these points.

The pickup in demand will reflect a number of factors. First, and most straightforwardly, it will reflect the progressive recovery in global activity, economic and financial, after the long period of post-crisis adjustment. Leverage will not return to the levels seen in earlier years – which is just as well. But it will recover as a more controlled credit expansion returns. Second, higher demand will reflect the full implementation, over time, of the new regulatory collateral requirements, boosting demand for fixed income instruments in particular. And, third, and perhaps most profoundly, it will reflect the fact that a larger share of post-crisis financial activity is likely to take place outside the banking sector, where securities financing is an unavoidable component of most conceivable financial structures. You may say you have heard this all before; the pickup in demand has certainly been delayed relative to initial expectations. But it will come.

Stronger demand will have an effect on collateral prices, and therefore on returns. Yields will rise as monetary policy in the developed economies begins to normalize. And the relative prices of in-demand collateral will rise, giving higher returns to the sell-side, and inducing a greater supply of high quality collateral from the buy-side. It will be interesting to see how many clients who say that it is not about price maintain that line in more normal market conditions!

The most interesting question is how higher demand and better returns will affect the future shape of the industry. And here my insights are frankly no better than anyone else's. But let me pose a few questions or thoughts. First, the owners of traditional balance sheets will be looking to make better, or more intensive, use of those now more-expensive assets: specialising in higher value-added business, seeking out new opportunities, perhaps in developing markets, perhaps in new instruments. The coming together of collateral management and wider balance sheet optimisation that I discussed earlier will be an important driver of this change. Second, collateral takers and givers will be looking to cut out stages in the chain, for example by exploring some of the peer to peer structures that have been much talked about recently (though as yet little seen). Third, the new universe of risk weights and incentives is likely to cause some rebalancing between cash, derivatives and financing markets as investors seek to optimise their positions. It is quite possible that may benefit repo and securities lending markets. And, fourth, there will be more intense focus on collateral optimization, both in-house and through market infrastructure, including trade compression and CCPs. The netting and capital weighting benefits of CCPs have long been recognised in repo markets. Securities lending is now starting to dip its first tentative toe into the water too. The Bank of England is watching these developments with interest.

We are really only in the foothills of this change process today. Most firms are still coming to terms with the implications of the new regulations, and ensuring compliance with them. Understanding how their business needs to adjust, and investing appropriately in new systems and structures, will take time. The thriving securities financing markets of tomorrow will also pose new risks, and central banks will need to be nimble enough to spot them. The collateral price adjustments needed to spur change may be large enough to have macroeconomic implications. New forms of business may develop even further outside the regulatory perimeter, so it will be particularly important to ensure sufficient transparency, both to regulators and to market participants themselves. That is why the FSB has placed such importance on developing repo and securities lending trade repositories and improved reporting in the years ahead. But central banks exist not just to bear down on risk, but also to foster safe, sustainable growth. And with that in mind, we have every interest in ensuring that there is indeed life after death for securities financing markets.

Thank you