15/11/2023

A CLEAR AND PRESENT OPPORTUNITY: CLEARED REPO FOR FUNDS

THE FUTURE IS YOU

SOCIETE GENERALE

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INTRODUCTION

*This presentation refers to the white paper published in October 2023 by **Dirk Bellens** (Head of Coverage Sales, Prime Services, SG) and **Jamie Gavin** (Head of Prime Services Clearing EMEA, SG)*

Clearing through crisis

This presentation analyses the evolution of central clearing since the Great Financial Crisis and explores some of the unintended consequences it has on liquidity during times of stress.

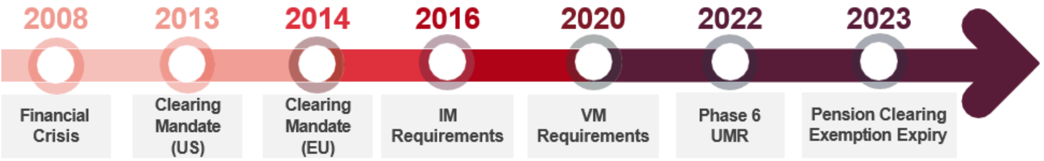
Benefits for financial market and clients

Clearing has its **benefits for the financial market** and end-users alike, but also introduces new challenges to the end-users.

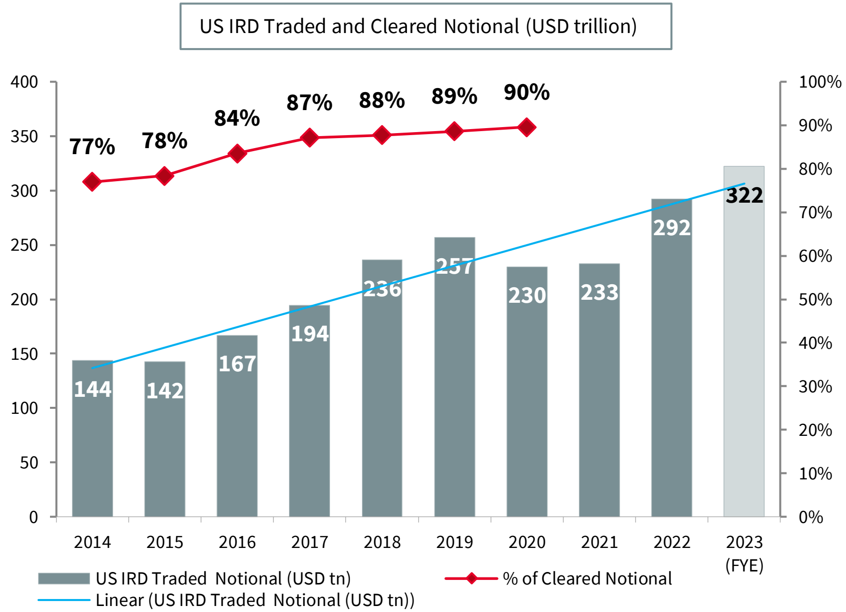
Cleared Repo, which allows the **buy side** for the first time **access to the cleared repo market**, is one of the exciting new **liquidity tools** for funds.

DON’T FIGHT THE REGULATORS – THE TREND TOWARDS CLEARING FOR FUNDS

The exemption of PSAs from mandatory clearing of most OTC derivatives finally ended on June 18, 2023.



THE RISE IN CENTRAL CLEARING CAN BE SELF-REINFORCING



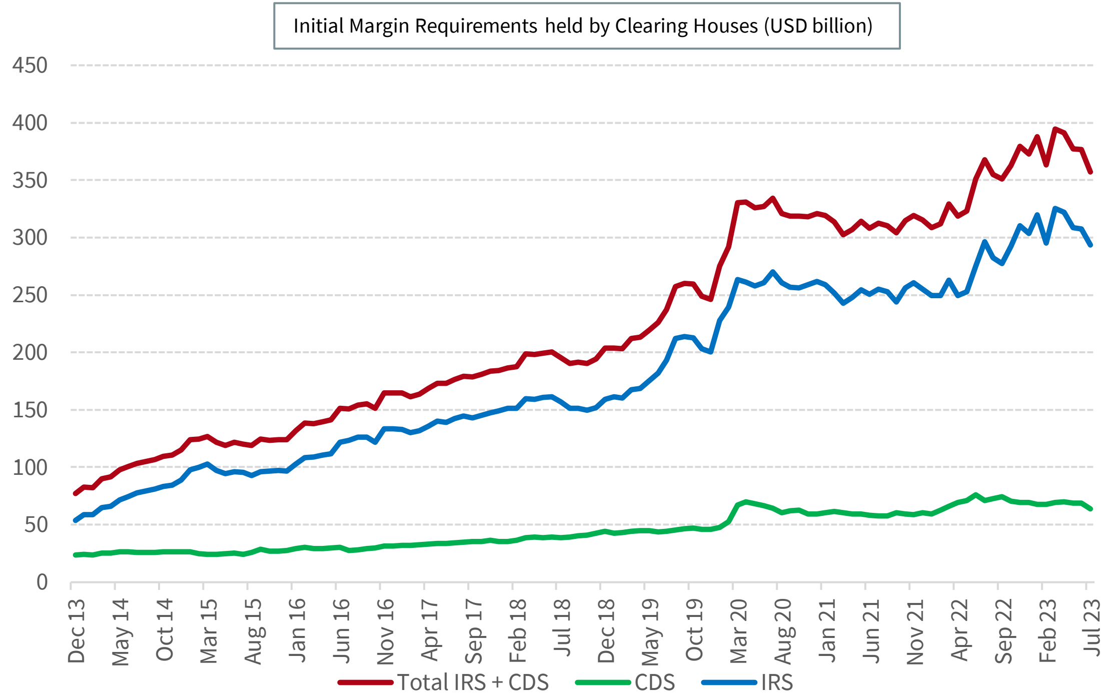
Source: ISDA Research Note: Evolution of OTC Derivatives Markets Since the Financial Crisis, published in January 2021. THE FIGURES RELATING TO PAST PERFORMANCES REFER OR RELATE TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

Liquidity shifts to Central Counterparty Clearing Houses (CCPs) and incentivizes other traders to move likewise.

→ Due to the regulatory push and more incentives to clear, clearing rates have increased substantially.

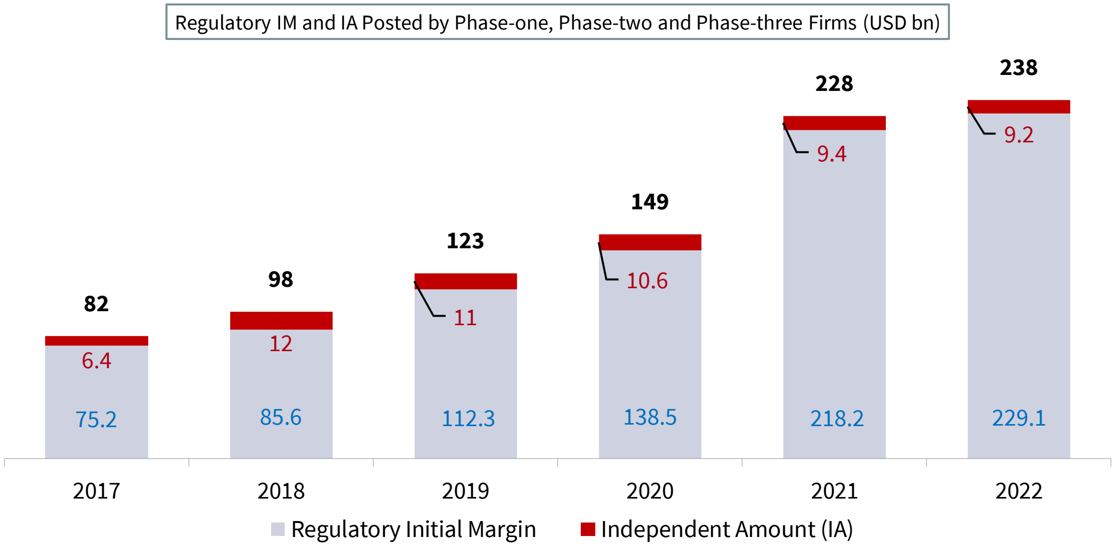
INCREASED NEED TO POST MARGIN

In the last 5 years, Initial Margin (IM) on cleared IR and CDS has doubled to approximately **$385Bn**, at the end of 2022.



Source: CFTC, as of 31 July 2023. THE FIGURES RELATING TO PAST PERFORMANCES REFER OR RELATE TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

DEVELOPMENT OF INITIAL MARGIN FOR UNCLEARED SWAPS



Source: ISDA MARGIN SURVEY YEAR-END 2022, published in May 2023. THE FIGURES RELATING TO PAST PERFORMANCES REFER OR RELATE TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

In parallel, the Initial Margin for uncleared swaps for phase-one, phase-two and phase-three UMR clients has almost **tripled** to approximately $240Bn.

OPERATIONAL CHALLENGES

Whilst the increased use of collateral and clearing has greatly reduced credit risk concerns, it brought at the forefront an increased focus on liquidity risk which, in turn, has its own operational challenges.

1

The exemption of PSAs from mandatory clearing of most OTC derivatives finally ended on June 18, 2023.

2

Variation margin calls due to unexpected changes in market prices can lead to liquidity stress in the system.

3

In centrally cleared transactions, intraday margin calls for variation margin that are not immediately passed through by the CCPs to their clients, can further absorb liquidity of market participants.

OPERATIONAL CHALLENGES

The liquidity flows for Variation Margin often dwarf those stemming from the Initial Margin.

End of 2022, the Variation Margin was almost 4x higher than the Initial Margin posted for uncleared swaps (≈ $805Bn).

Different from bilateral margin calls on non-cleared derivatives, VM on cleared portfolios needs to be met in cash, given the pass-through required at the CCP.

In 2020, ESMA estimated that a 100-basis point move in Euro rates would require almost €68bn of cash collateral for Dutch pension funds and close to €100bn could be needed for the combined needs of Dutch, Danish and Irish funds using swaps.

RISING LIQUIDITY NEEDS IN CHALLENGING ENVIRONMENT

Collateral management crises for funds appear to be an emerging “new normal”. (ex; Covid crisis - March 2020, Russia invading Ukraine – February 2022, LDI crisis – September 2022)

The rise in global interest rates to combat inflation has only added to the likelihood of intermittent liquidity pressure for funds.

Source: Bloomberg, September 2023. THE FIGURES RELATING TO PAST PERFORMANCES REFER OR RELATE TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

One of the chief lessons is the need to have a reliable source of cash for margin calls - on an intraday basis if possible - and holding larger cash buffers will be another likely outcome.

CLEARED REPO COMES TO THE RESCUE

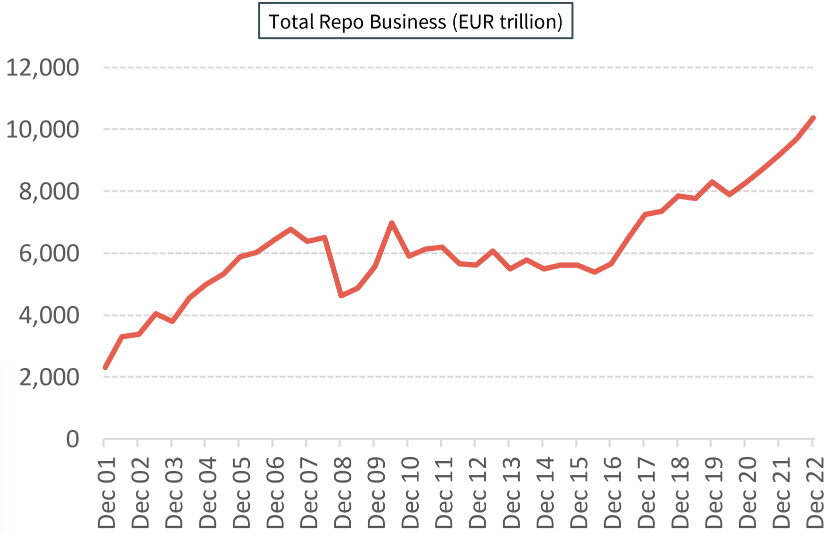
After the liquidity stresses that we have experienced over the past few years, the Bank of England identifies three areas that policy makers have been working on to mitigate these vulnerabilities:

- **Work to increase the resilience of non-banks to future liquidity shocks**
- **Enhancing market intermediation capacity**
- **Design of central bank tools to address market dysfunction and availability to more market participants**

REPO TRANSACTIONS

Repo transactions are increasingly seen as valuable tools by treasury desks to access short term liquidity in an efficient manner without jeopardizing fund performance.

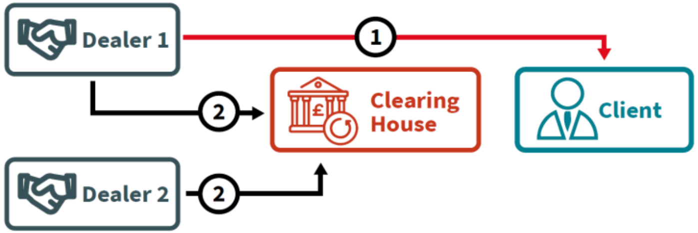
Around 60% of the repo market in Europe is cleared. Until recently this pool of liquidity was only directly accessible by sell side banks.



Source: International Capital Market Association European Repo Market Survey Number 44, conducted December 2022, published March 2023. THE FIGURES RELATING TO PAST PERFORMANCES REFER OR RELATE TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR OF FUTURE RESULTS.

BILATERAL REPO VS CLEARED REPO

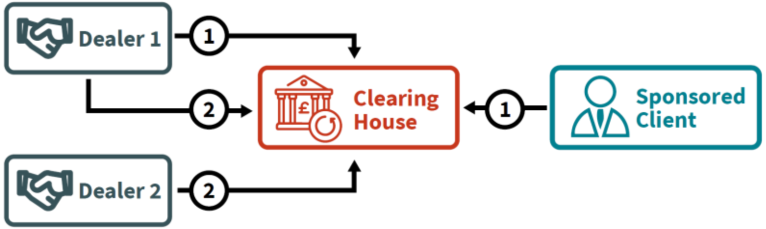
BILATERAL REPO



1. Initial trade is bilateral, Client vs. Dealer 1
2. Dealer 1 hedges with Dealer 2

- Only the Dealer-to-Dealer trade is cleared
- Therefore, leverage is created between both D1 and D2 as well as between D1 and client

CLEARED REPO



- Both trades are cleared (initial client trade + hedge)
- No leverage created for Dealer 1 as the CCP is the only counterpart to both legs

→ **In Europe, both Eurex and LCH offer access to the cleared repo market for pension funds and insurance companies.**

BENEFITS FOR FUNDS

Liquidity - Access to a larger and deeper pool of fixed income liquidity making it easier to get financing in times of stress or over month-end periods.

Documentation - Access to more providers without additional GMRAs through the one-off execution of legal documents with the CCP & sponsoring bank.

Operational efficiency - Reduced operational requirements versus settling bilateral trades against multiple brokers.

Improved pricing - Reduced leverage cost and netting benefits for banks which should feed through into general pricing.

Risk - Reduced bilateral counterparty risk exposure as funds are facing CCPs.

WHAT COMES NEXT?

The trend towards greater use of clearing by funds is unmistakable, due to a combination of formal regulatory mandates and growing appreciation of related benefits by fund managers. Cleared repo solutions can play a key role in easing this transition.

Any interested party should consider assessing the liquidity and business benefits, reviewing the onboarding processes and documentation required for set-up and select a clearing partner with the necessary experience and expert knowledge to begin the next steps.

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Q&A

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