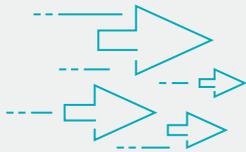


Repo Clearing: Reducing Uncertainty and Counterparty Risk in Volatile Market Conditions

By Corentine Poilvet-Clediere and Antony Baldwin

LCH The Markets' Partner

RepoClear



In unpredictable market conditions, predictability, transparency and the ability to switch risk appetite rapidly — all within the deepest liquidity pool — is critical.

Ongoing geopolitical and macroeconomic developments — including inflation and interest rates hikes — have created challenging conditions for repo market participants in 2022, driving surges in volatility and periods of market stress. In addition, following the UK government's fiscal plan announcement, in September and early October the UK Gilt market experienced extreme volatility, impacting both sell-side and buy-side participants.

With many liability-driven investment (LDI) funds reportedly facing difficulty in finding sufficient collateral with immediate liquidity, the Bank of England was forced to intervene. Additionally, [ICMA has expressed concerns](#) over current Eurozone repo and money market conditions and banks' reduced capacity to intermedate in these markets.

Although these forces are beyond the control of market participants, it is possible to mitigate their impact by:

01. Offering new models that can reduce banks' capacity constraints
02. Optimising resource allocation
03. Improving settlement performance and efficiency for securities transactions

In unpredictable market conditions, predictability, transparency and the ability to switch risk appetite rapidly — all within the deepest liquidity pool — is critical. Repo clearing delivers on these requirements and has never been more relevant.

CCPS — SAFE HARBOURS IN A STORM

As geopolitical shocks and market turmoil become increasingly commonplace, clearing participants expect their CCP to provide stability and respond predictably to the ever-changing environment, which LCH has done consistently, adapting as conditions require.

Clearing at LCH RepoClear benefits the entire repo market by providing access to deep liquidity, netting opportunities and enhanced risk management — a larger ecosystem means greater efficiency benefits for all participants and the overall reduction of systemic risk for the market.

PREDICTABLE RISK MODELS AND MARGIN STABILITY

A CCP's likely reaction to different market events should be as predictable and transparent as possible, so that stakeholders connected to the clearing ecosystem (including clearing members, clients, interoperable CCPs and regulators) are in the strongest position to fulfil their respective roles and responsibilities, thus ensuring the increased stability and resilience of financial markets.

As margin model stability is crucial for market participants, it is a constant focus at RepoClear and across LCH more widely. Our risk management models performed as designed when tested during the onset of the COVID-19 pandemic in 2020. Significantly, there were no changes to the timing and number of margin calls, or to the models and methodology themselves, even during the height of the crisis.

During the recent Gilt market volatility, LCH Ltd's RepoClear service saw an increase in volumes, as participants sought reliable access to cleared liquidity shielded from the market turmoil. Any adjustments to default fund requirements and risk models made due to market conditions were predictable, within expected BAU parameters, and communicated to members in advance and with no changes to our rules.

At LCH SA's RepoClear service, the 13 Euro debt markets recently moved to an enriched VaR risk methodology, which is also live for Gilts at LCH Ltd. VaR provides members and clients with the ability and efficiency to reduce margin requirements on diversified and balanced portfolios — the flatter the risk brought into the system, the higher the reward, which frees up margin. The VaR model will also apply to LCH SA's €GCPlus segment following its integration with RepoClear at LCH SA (planned for Q1 2023 and subject to regulatory approvals).



Strengthening capacity to manage liquidity and transform securities into cash is a key consideration for pension funds, which will be required to post variation margin (VM) to the CCP.

WIDENING ACCESS TO CLEARING

Buy-side access (enabling the ability to execute with the wider RepoClear membership) is unlocked by RepoClear's Sponsored Clearing model. Additionally, following our open access approach, RepoClear is connected to a broad range of trading venues and settlement locations, providing extensive choice, and continues to build connections where users most need them.

This is particularly important, as the EMIR 2.2 interest rate swap clearing mandate exemption for Pension Scheme Arrangements (PSAs) is ending in June 2023. Strengthening capacity to manage liquidity and transform securities into cash is a key consideration for pension funds, which will be required to post variation margin (VM) to the CCP.

Sponsored Clearing addresses PSAs' liquidity management and operational limitations by providing efficient access to the cleared repo market, where non-cash collateral can be transformed into cash to meet VM calls. As direct clearing members sponsored by an agent, PSAs can use the operational services of the agent to post VM cash on their behalf, while continuing to access the benefits available to direct members.

Although change in financial markets takes time, by working in close partnership with the market, LCH continues to innovate to enable a broader range of buy-side firms to access cleared repo, alongside the existing PSAs, LDIs, money market funds and regulated funds that are already clearing. This includes collaboration to develop a workable guaranteed Sponsored Clearing model, which, if approved by regulators, will extend access to certain categories of alternative investment funds, allowing them to benefit from access to RepoClear's significant cleared liquidity pools.

LCH will continue to work to bring efficient longer-term structural benefits to its members and the wider market.



The report, which is supported by DTCC, urges US regulators to make it easier for principal trading firms (PTFs) to clear US Treasuries at FICC, which could lead to cash bonds and additional repo trades becoming potential candidates for clearing.

THE INDUSTRY DIRECTION OF TRAVEL

Following the turbulence in the US Treasury market in March 2020, regulators and industry bodies have turned their attention to additional instruments that should be considered for clearing.

In 2021, The Group of Thirty Working Group on Treasury Market Liquidity (G30), an influential think-tank of policymakers and market practitioners, published recommendations in its [US Treasury Markets report](#) for improving the resilience of this market, at a time of increasing government bond issuance. The report, which is supported by DTCC, urges US regulators to make it easier for principal trading firms (PTFs) to clear US Treasuries at FICC, which could lead to cash bonds and additional repo trades becoming potential candidates for clearing.

In September 2022, the [Securities and Exchange Commission \(SEC\) proposed rule changes](#) that would enhance risk management practices for central counterparties in the US Treasury market and facilitate additional clearing of US Treasury securities transactions. SEC Chair Gary Gensler said, "There is more work to be done with respect to the amount of Treasury activity that is centrally cleared. I think that these rules would reduce risk across a vital part of our capital markets in both normal and stress times". While discussions to date have been focused on reducing risk in the US market, there remains potential for similar discussions to develop within the UK and Europe.

While it is hard to know what lies ahead or what the source of future tensions might be, liquidity, cash/collateral balance and market pricing dynamics as we have known them will change. Against this backdrop, central clearing provides a safe harbour of stability and predictability.

LEARN MORE

Visit the [Sponsored Clearing](#) page on LCH.com and [download the brochure](#).

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To find out how to become a Sponsored Member contact us at reproclearmembershipsales@lch.com.

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