Move this way

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“The markets are moving and being directed toward open and transparent exchanges such as Elixium, where counterparties can trade all to all on a level, equitable and unbiased playing field.” Roberto Verrillo explains.

Changes to the regulatory environment have put the industry on a path that will change it forever. The effect of these changes has been an almost uniform decline in profitability for investment banks. Many operations have already begun efforts to restructure large areas of their businesses to maintain returns on equity that are acceptable to shareholders. This process will continue for several years yet.

In particular, Basel III significantly increases the cost of doing business, taking risk and market making by ‘taxing’ the cost of the balance sheet via increased capital requirements such as the leverage, liquidity coverage and net stable funding ratios. The more balance sheet-intensive a particular business area is, the higher the hurdle rate for returns should be. In this regard, bond trading and market making and repo stand out.

Many firms have not yet implemented an exhaustive study of what these hurdle rates should be. These are not standard across the industry but are firm specific and are calculated using varying inputs particular to each individual institution. Ultimately, these metrics will decide what each institution’s balance sheet will cost.

We believe that as this process of re-pricing and charging business areas for the regulatory cost of partaking in certain businesses (and transactions) progresses, the market will find many more institutions cutting back and restructuring their current business models, or simply pulling out of certain businesses altogether.

A good example is the net stable funding ratio (NSFR) under Basel III. This will lead to the necessity for longer dated deposits, particularly corporate deposits, which are treated favourably for banks under the rules.

NSFR provides for different available stable funding (ASF) and required stable funding (RSF) weightings depending on the type of counterparty and the residual maturity of the transaction. This will make many financing transactions that are still viable under current regulatory capital treatment extremely onerous.

A 50 percent RSF weighting will be applied to all loans, including reverse repos, to non-banks, regardless of the residual maturity of the transaction, and independent of the underlying asset.

In other words, this would mean that all reverse repos with non-banks under one-year maturity would require the provision of stable funding against 50 percent of the value of the reverse repo. For example, a bank transacting a $100 million overnight reverse in AAA government bonds with an insurance company or hedge fund would carry a requirement for $50 million of (long term) stable funding, even if this reverse was match-funded by repo.

The cost of providing balance sheet to customers that may simply require a home for their cash has become increasingly prohibitive, leaving some banks having to turn away short-term deposits and repos and charge what might look like unreasonable costs for accepting these deposits, or even to only offer the facility to clients from which they generate revenue on other products as part of a wider relationship.

Because of this lack of willingness to, or difficulty in, pricing collateral transactions, many of these transactions become economically unviable, backward dated pricing and resulting dysfunctional collateral markets are in evidence over reporting periods such as month-, quarter-, half- and year-end but increasingly over a normal date run—volumes and liquidity are both showing signs of drying up.

Banks can make significant cost savings by accessing liquidity pool providers such as Elixium for distribution. This leads on to the next area of regulation that needs to be addressed.

Initial margin and variation margin for uncleared over-the-counter derivatives will be phased in from September 2016 through to June 2021. The US will begin the initial margin programme from September 2016 for the largest of counterparties, but the EU has delayed the start of its programme until June next year.

Clearing banks that traditionally put up money to support default funds within central counterparties (CCPs) are increasingly reluctant to do so as they have to hold a significant amount of capital on their balance sheet to support this business.

Variation margin to CCPs must be in the form of cash, creating a need for collateral-to-cash transformation. The size of the potential problem cannot be underestimated as banks step away from providing balance sheet to support short-dated, low margin repo activity.

CCPs are working to engage buy-side counterparties via differing initiatives, be they sponsored or direct CCP membership.

It is envisaged that mandatory swaps clearing in Europe could create unprecedented demand for high-quality liquid assets and their transformation, for use in initial and variation margining of swaps. Eventually, CCPs may offer cross-netting capabilities across a range of products.

The repo and secured lending markets are an intrinsic component to any financial market. They provide the ‘engine’ that allows markets to function successfully. In particular, collateralised markets provide: secured money market funding; the facilitation of central bank operations; liquidity in secondary debt markets; equilibration of imbalances in supply and demand; prevention to distortions in yield curves; pricing of derivatives; and margin maintenance for OTC and other products.

Clearly, the market has a problem with recycling its cash and securities at a reasonable cost due to the adverse balance sheet treatment and cost that the new regulations have created. As a result, liquidity and volumes are being adversely affected and markets are becoming increasingly dysfunctional. Imminent swaps regulation will make the lack of depth, liquidity and volume ever more apparent.

Many new counterparties now want to enter the secured lending market via repo but find the barriers to entry too prohibitive. Banks, the traditional conduits for this process, have been hit hardest and traditional trading mediums are outmoded and outdated. The markets are moving and being directed toward open and transparent exchanges such as Elixium, whereby counterparties can trade all to all, on a level, equitable and unbiased playing field.

Elixium is a global all-to-all electronic marketplace. It is designed to provide a transparent and unbiased venue for trading collateral and seeks to address the issues around liquidity that have been affected by on-going market evolution. As a multilateral trading facility for collateral and secured deposits, Elixium is targeted at firms of various size and constituencies, including corporate treasurers, CCPs, asset managers, hedge funds, banks, government issuers, central banks, insurers, and agencies.

Elixium has been explicitly designed to address the impact of regulation, balance sheet pressures and deteriorating levels of liquidity in the repo market by providing participants with collateralised liquidity on a fair, transparent, low-cost and equitable basis.

While the demand and client benefits are clear, many new counterparties are continuing to face high barriers to entry when seeking to access collateralised liquidity. We have also adopted a user-friendly modular approach to documentation with the option to either subscribe to the Elixium standard global master repo agreement (with bespoke annexes) or utilise existing documentation between counterparties.

The platform further provides a full credit limit framework where the participant retains full control over the products and firms with whom they are willing to trade. Institutions will be able to qualify for credit slippage, view depth and liquidity across tenors and collateral baskets, and offer varied execution functionality. Finally, using standardised products and processes, firms will have access to a range of maturities, currencies and collateral baskets, and will be able to facilitate collateral upgrades and new trading strategies via cleared, triparty and domestic settlement. Over the coming months Elixium will expand its initial offering to over 40 collateral baskets covering fixed income and equities in GBP, EUR, USD, CAD, JPY, and emerging markets. SLT