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Are The Days Numbered For The Broker-Dealer Repo Matched-Books?

On Tuesday, April 8, federal regulators (Federal Reserve, FDIC, and OCC) finalized the supplemental leverage ratio ("SLR") caps for the eight largest US banks (BNY Mellon, Bank of America, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, State Street, and Wells Fargo). These Systemically Important Financial Institutions ("SIFIs") will have to raise their leverage ratios to 5% for their bank holding companies and 6% for their insured subsidiaries beginning January 1, 2018. The new rules may force these largest banks to hold another $68 billion in capital. The Fed's Tarullo indicates that he wants to go even further, signaling that the central bank may boost the risk-based capital surcharge to a higher level. On Thursday, CNBC ran an article that likened the combination of the SLR plus three pending uncertain, requirements (described below) as the "Four Horsemen of the Apocalypse." The three additional, potential requirements are:

1. a surcharge for the largest global banks;
2. additional capital rules for banks that rely on short-term funding (which has been a pet project of Tarullo); and
3. a requirement for banks to hold much more long-term debt to make it easier for regulators to unwind them

The US regulators may need to fine-tune how these ratios are calculated to bring them in line with the international Basel III leverage standard (3%) to come in January 2018. Also of note in the new regulations is balance sheet netting (transactions in the same security type, in opposite directions for the same term, with the same counterparty) will no longer be allowed. In addition, regulators are looking at an average balance sheet at the banks, no longer allowing room for historical fluctuations by banks taking snapshots at month-ends or quarter-ends.

This is all likely going to put another large dent in available balance sheet for repo at the largest banks, something which has dropped by an estimated 60% since 2007. The fixed income market is also concerned about how these new leverage ratios will impact low-risk assets, such as US Treasuries, and their issuance. The Fed has acknowledged the possibility that "it is possible that covered organizations' cost of holding low-risk, low-return assets could increase if it becomes the binding regulatory capital constraint", but that the Fed has a "flexible and diverse policy toolkit that can offset most, if not all, unwanted pressures that may develop" in the rate market as a result of SLR.

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While the new requirements alone could lead to a further drastic balance sheet deleveraging by the top eight banks, there may be worse news than that out there for repo desks. I saw several articles last week, including a very strong one from Deutsche Bank, regarding Net Stable Funding Ratio ("NSFR"), which is destined to become the minimum leverage standard by January 1, 2018. NSFR, along with Liquidity Coverage Ratio ("LCR"), are the two landmark requirements of Basel III. They are expected to be applied to all banks worldwide, if they are engaged in international banking activities. The NSFR seeks to calculate the proportion of long-term assets (defined as 100% of loans longer than 1 year, 85% of loans to retail clients with a remaining life less than 1 year, 50% of loans to corporate clients with a remaining life less than 1 year, and 20% of government and corporate bonds) on the balance sheet that are funded by long-term, stable funding. Stable funding includes customer deposits, long-term wholesale funding, and equity issuance. Stable funding excludes short-term wholesale funding. The NSFR standard must be met in January 2018.

The LCR will gradually be implemented, starting from 2015 at around 60%. The implementation will be completed in 2019 and the final ratio could be higher than 100%. So, from a repo perspective, the NSFR provides for different Available Stable Funding ("ASF") and Required Stable Funding ("RSF") weightings/factors depending on the maturity of the trade and securities as well as the counterparty type. The most damaging weighting suggested so far is the 50% RSF factor applied to reverse repos to non-banks, regardless of underlying asset type or repo transaction maturity. It could mean that for every $100mm overnight reverse repo in overnight gilts (or any AAA sovereign) from a leveraged account, there could be a requirement for the bank to have $50mm in stable longer-term funding against it (with no provision for offsetting repo with the same maturity, asset type, and counterparty). Risk.net says some banks have estimated that this could increase the cost of some repo transactions for those banks by 850%.

I have been maintaining in the AVM Repo Commentary and in conversations with many of you that the ultimate, larger goal of regulators through smaller, sector-oriented regulation proposals (such as Money Market Fund Reform, Triparty Repo Reform, Leverage Cap Ratios, etc.) may simply be to rein in the FSB's [what is FSB? Not defined] estimated $68 trillion in "Shadow Banking" (the multiple rehypothecation of the same securities, the excessive use of special purpose entity and structured investment vehicles, and the use of off-balance-sheet-funding-like lines of credit). It appears that the regulators' efforts, although on varied specific subjects, have been pretty well-coordinated. These Basel III proposals would go a long way to accomplishing that larger goal of reducing Shadow Banking. The regulators and G20 have focused on the 2007 financial crisis and specifically the liquidity crisis that Bear Stearns and Lehman Brothers (among others) suffered due in part to their over-reliance on short-term wholesale funding in the interbank lending market.

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The dichotomous trend [which dichotomous trend?] has gotten more prevalent, in my opinion. Broker-dealers are trying to push their rapidly shrinking repo matched books out to longer maturities and trying to demonstrate longer term liquidity by cajoling cash providers to extend to 6 months to 1 year term. Much of this is because of new regulatory proposals that punish the broker-dealers for staying short-term (Basel III, Dodd-Frank, SLR, leverage caps, Triparty Repo Reform) and fixed income managers at the banks looking to allocate balance sheet only to the widest bid/offer spreads and terms. In addition, we've seen that many broker-dealers are also allocating their balance sheets to wider bid/offer spread products (such as corporate bonds, emerging markets, ABS, Private Label RMBS, etc.), and out of government securities, acknowledging that if they have shrinking balance sheets, but they would like to capture as much bid/offer spread as possible with what they have. It is possible, per a Deutsche Bank article recently, that bid/offer spreads, particularly for repo with maturities of overnight to 3 months, could widen dramatically with the impact of SLR and Basel III. Meanwhile, on the other side of the coin, cash providers are being pushed by other regulatory proposals and internal investment policies to go as short a term as possible (Money Market Fund reform, Dodd-Frank, risk diversification), to maintain liquidity for their investors and to reduce their credit exposure to the broker-dealer community. So, you have cash providers looking for short-term repos and broker-dealers looking for long-term repos, which may ultimately push actual cash providers and collateral providers to speak with each other and transact repo with each other (preferably through AVM's Direct Repo™ product). For those who can't adapt to this environment or who have difficult-to-change investment policies, the available supply of liquidity and eligible counterparties could be dropping at an alarming rate.

If you would like to see some more information about Direct Repo™ check out our website http://www.avmsolutions.com. Remember that in Direct Repo™, AVM acts as introducing broker, not a principal, to end-user cash providers and collateral providers, pairing the two up to provide needed additional liquidity to the repo market. You can also give me a call or send me an email.

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