The unintended consequences of leverage ratios

Are recent declines in repo volumes a result of efforts by central banks to drive out risk and will these measures have the desired effect on market practice?

Advocates of tighter regulation on financing activities since the financial crisis have argued that there is a need to somehow leech risk out of the global financial system, thereby reducing points of vulnerability. However, as Richard Grasso, former chairman and CEO of the New York Stock Exchange once noted, "There are always unintended consequences of any legislative or regulatory act that's taken in the heat of battle."

In recent months, the impact of regulatory innovations on collateral management, and particularly repo transactions, have come to the fore. In a collateral management study conducted in December 2012 among industry participants in the UK, France and Germany and released by SIX Securities in early May, 45% of participants said that collateral management was at risk of becoming a commodity, while a further 30% al-

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ready considered it a commodity. As Robert Almanas, head of international services, SIX Securities Services, told Radar at the time, "I suspect that these results would change significantly if collateral shortages become a reality." Access to collateral, optimisation of collateral, and continued compliance to changing regulation would, he suggested, demand comprehensive servicing capabilities. "It is hard to imagine that decisions in this context will be purely 'utility based'. Value-added criteria must be factored into the decision making process," Almanas argued. "It is a frightening prospect that in today's market, over a third of financial institutions are willing to accept collateral simply because it is cheap."

Tellingly, 57% of respondents agreed that the price of collateral is more important than quality. In the race to find collateral, 48% of respondents said that securitising and repackaging existing portfolios to create new collateral pools could result in additional risk and sow seeds for the next crisis. "When our competition begins to compete on the quality of collateral they are prepared to take, the 'race to the bottom' becomes a very real outcome," said Almanas.

Since then, the industry has debated whether at the heart of matter is a shortage of collateral globally or simply a scarcity as a result of the collateral being in the wrong place at the wrong time.

Repo plays a fundamental role in the management of that collateral. Earlier this year, at the time of general industry febrility on the issue of a Financial Transaction Tax, ICMA's European Repo Council (ERC) issued a paper outlining the importance of collateral to the stability and efficiency of the financial system. The paper noted that

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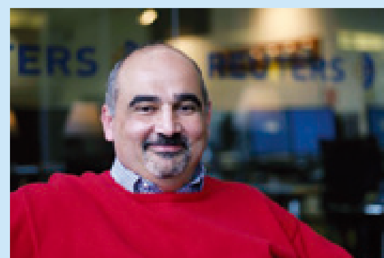
Richard Comotto | ICMA

global regulatory initiatives such as Basel III are built on the even more extensive use of collateral. "Collateral is essential to the intermediation of credit through the financial system to the real economy, which makes it of macro-economic importance," the paper argued. "Furthermore collateral is also the link between the financial markets and central banks and therefore crucial to the conduct of monetary policy." The paper, produced for the ERC by Richard Comotto, a visiting fellow at the ICMA Centre at Reading University, pointed out that collateral is priced, mobilised and moved in the repo market.

"Every single home owner understands the value of collateral, as home loans are only available from mortgage providers against the security of bricks and mortar," noted Godfried De Vidts, chair of the ERC. "Similarly, for today's financial markets, collateral represents the raw material underpinning the G20 regulatory requirements for safer centralised and bilateral clearing, as well as the implementation of central bank monetary policy."

In late August, however, a threat to that market was identified in the shape of the supplemental leverage ratio, being proposed both by the Federal Reserve and regulators in other major markets. According to a report by *Reuters*, senior Wall Street executives had suggested that the new measure "could drain appetite for the US Treasuries market and raise costs of funding for many institutions."

Bank supervisors were apparently concerned that that the repo market was unstable under pressure. "A run on Lehman Brothers in the repo market in 2008 was one of the main reasons why the investment bank collapsed," *Reuters* quoted a senior Treasury source as suggesting.

Comotto believes that the fears of the banks regarding the impact of this new measure are credible, suggesting that the supplemental leverage ratio could severely damage the repo industry and encourage banks to hold riskier assets.

The supplemental leverage ratio has its roots in the belief that risk weighted capital calculations have proved insufficient and that risk weightings have had pro-cyclical implications. Under the latest version of the leverage ratio, regulators will not allow netting in repo: if money is borrowed and loaned in repo, regulators will not net the

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two transactions. According to Comotto, this will encourage banks to dispose of low risk assets and focus their business on high-risk assets. "If banks have government bonds on their balance sheet, these are low risk weighted assets so you may be keeping very little capital [e.g. 1%] against them because the risk on them is low," he explained in an interview with *Global Custodian* magazine. "If you are keeping 1% against those holdings, the leverage ratio suddenly says this leverage should be at least 3% capital coverage so you have to triple your capital. Whereas if you are holding a risky asset with a risk weight of 5%, that's no problem; you are already holding 5%."

This will severely damage the repo business, Comotto argues. "It is generally against government bonds so it's a low margin business, but it's been profitable because it has been a low capital business. Now if it becomes a high capital business because of the leverage ratio most banks will cut it back. If they cut back what they do in repo, liquidity in the repo market obviously drops and the cost of bonds goes up, particularly government bonds."

"The whole structure of Basel is to encourage the use of collateral," says Comotto, "but they are basically saying if you lend any money because it has collateral against it, they will penalise it by imposing this capital charge."

The summer months in Europe and the US have traditionally not been an ideal time to judge longer-term market trends. It will therefore be interesting to see if, as winter approaches, fears of unintended consequences from the latest round of leverage regulations are confirmed. •