

Box 7

THE WIDENING OF THE COLLATERAL POOL FOR SECURED LENDING IN THE EURO AREA

Trading in the euro area secured money market has been growing significantly in recent years. According to the ECB's Euro Money Market Survey,¹ by 2002 the secured market had already become the largest segment in the euro area money market. In addition, according to the International Capital Markets Association (ICMA) European repo market survey, outstanding

¹ According to the survey, the secured market saw growth rates of 142%, compared to 15% in the unsecured market between Q2 2000 and Q2 2005 (see also Box 6 on structural trends in the euro money market).

repo transactions in the European market saw annual growth of around 16% between December 2004 and December 2005, mirroring growth rates seen in surveys in previous years.² As the recourse to secured borrowing has been increasing, so too has market participants' need for more collateral. While a shift from unsecured to secured borrowing should be positive from a financial stability viewpoint, there have been some concerns that the quality of the collateral used in these transactions has been deteriorating. This Box describes some of the more important developments in the collateral pool for secured lending in the euro area and it assesses their implications for financial stability.

Because government debt issuance in the euro area has, in recent years, been growing at a slower pace than the repo market, there has been a pressing need to find alternative securities to serve as collateral. The ICMA survey has found, for example, that the share of collateral issued by EU governments in total EU collateral steadily declined from about 92% in December 2001 (according to the first repo survey) to 86% in December 2005. By comparison, the share of US Treasury securities in outstanding repo business has ranged between 56% and 66% over the past five years, with agency and mortgage-backed securities (MBS) accounting for about 15% each, and corporate bonds making up the rest.³ While the share of government bonds in the European repo market is higher than in the US, the alternatives to government bonds in Europe now include not only high-quality corporate and covered bonds, but also financial securities such as equities, junk bonds and asset-backed securities (ABS) – assets that would not have been used as collateral just a few years ago. The use of such assets in Europe is more significant in the tri-party repo business than in bilateral repo transactions.⁴

The structure and quality of collateral used in European tri-party repos, as shown for example in the ICMA survey,⁵ reflects the changing quality of the collateral used in European repos. It also reveals differences in the use of tri-party repos between the European and US markets. In Europe, tri-party repos are more often used by banks and dealers as a tool for financing positions in securities that would otherwise be difficult to use in bilateral repos, owing either to their high trading frequency, small size or lower credit quality. Investors' decisions to use tri-party repos in Europe may sometimes be driven more by the extra yield offered by banks and dealers in return for accepting riskier collateral. In the US, on the other hand, tri-party repos are a standard instrument for cash investors, and are used by banks and dealers to finance their holdings in Treasury securities. In the European markets, government bonds are more frequently used in bilateral repo transactions.

An additional feature that may support the more extensive use of private sector bonds in the European repo market is that the ECB accepts a wide spectrum of collateral from various types of issuers in its refinancing operations, including corporate bonds, covered and uncovered bank bonds and ABS. This may add another incentive for market participants to accept such collateral in their secured cash lending, as they have little uncertainty of obtaining liquidity for such collateral in the ECB's refinancing operation. The increasing use of lower quality collateral in repos does however pose the problem of proper collateral valuations. Individual assets, even whole asset classes, are frequently difficult to value. Additional uncertainty may come from

2 See ICMA (2006), "10th European repo market survey, December 2005". The survey also estimates the total size of the European repo market at more than €5,800 billion.

3 Data were obtained from Federal Reserve Bank of New York weekly reports on transactions and financing by primary dealers.

4 In tri-party repos, collateral management functions are delegated by the two counterparties to a third-party agent, usually to ease the burden of back office functions on the cash investor and to allow a more efficient use of collateral by the cash-taker in the repo.

5 The survey found that the share of government bonds used in tri-party repos fell significantly to 23% in December 2005, down from 26% in June 2005 and 44% in December 2004.

the fact that for some assets, prices may be available but are subject to large fluctuations because the market in such assets is rather illiquid. Without proper collateral valuations, the collateral-taker will be exposed to the risk that in the case of a default of the collateral provider, the amount of collateral may not be sufficient to cover the value of the cash investment. This risk increases as the credit quality and liquidity of the assets decreases.

The growing use of private sector securities as collateral in repo transactions has also been reflected in the growing prime brokerage business that banks and dealers now offer to the hedge fund industry. As the prime brokerage business began to become more competitive with the entrance of new banks, collateral quality criteria became the subject of competition as banks attempted to obtain new business from hedge funds. In this respect, a study by Greenwich Associates⁶ found that in Europe, dealers were lowering credit quality requirements for collateral on their hedge fund repo business. According to the survey, in 2004 just under 55% of dealers would have accepted collateral of lesser quality than government or agency securities; by 2005, this number had risen to 70%. The size of haircuts (an extra amount of collateral or cash given by one party to the other in order to smoothen the effects of changes in the market price of the collateral) on repo collateral, which are frequently used to manage banks' credit exposures to their customers, have also come under pressure from competition between banks in the prime brokerage business. Because of this, concerns have been expressed that the haircuts applied may not always accurately reflect the risk associated with the customer or the quality of the collateral.

The implementation of the Basel II Accord should have some impact on the repo market. The Accord's emphasis on the quality of collateral may result in changes in the relative pricing of collateral, and could eventually also influence its pricing in the cash market. As lower-rated collateral will become less attractive, there may be an increase in the use of some higher-quality asset types.

All in all, the increasing use of collateral in borrowing and lending transactions is to be welcomed because it enhances legal certainty and credit protection of lenders. As a result, credit events with a systemic impact can be more easily avoided. An additional benefit is that more liquid money markets can develop, allowing a more efficient allocation of capital. However, this needs to be monitored closely, as collateral quality may have a significant impact on the position of the collateral-taker should a credit event occur. As valuations of more exotic collateral are, in most cases, difficult owing to the unavailability of prices and often low secondary market liquidity, especially in stressed markets, collateral-takers may find themselves in a less secure position than they thought when entering into the trade.

⁶ Greenwich Associates (2006), "In Europe, hedge funds compete for assets while dealers compete for hedge funds", 24 January (press release).