Article

Financial markets

The repo market: slow but sure

Content available in
Spanish Catalan

One of the critical points in the financial crisis of the last few years took place at the end of 2011. In the midst of doubts whether the euro would survive, there was a crisis of confidence regarding the capacity of numerous banks to meet their commitments. For some, access to wholesale financing markets, both monetary and capital, had practically shut down. Given the emergency, at its meeting on 8 December 2011 the ECB took an unprecedented decision: to carry out two special three-year long term refinancing operations (LTROs). Mario Draghi explained that the aim of this measure was to shore up liquidity in the banking sector given the highly serious restrictions. Without doubt, the LTROs carried out on 21 December 2011 (used by 500 banks and assigning 489 billion euros) and 29 February 2012 (in which 800 banks requested almost 530 billion) were a lifesaver for European banks as they almost neutralized the risk of illiquidity. In this respect, they were a success.

However, there is another, less positive interpretation: these two LTROs exacerbated banks' addiction to ECB funding. This circumstance is highlighted when we observe the drop in the volume traded on the European repo market, an extremely important source of short-term funding for financial institutions. A repo (the abbreviation for repurchase agreement) is used to obtain liquidity in exchange for pledging a financial asset as collateral against default. According to the data published recently by the ICMA (International Capital Market Association), Europe's volume of repo contracts shrank to 5.6 trillion euros at the end of 2012, down 10% on the figure for December 2011. This occurred in spite of the fact that the repo market has benefited from a reduction in unsecuritized interbank loans.

According to its critics, the generous amount of surplus liquidity provided by the ECB discouraged operations between banks, delaying the return to normality. According to its defenders, the action taken by the ECB has prevented a disaster and is designed to ensure a gentle, gradual normalization. Several signs support this second interpretation. For example, the early repayment of LTRO loans. The most vulnerable parts of the market have also reacted positively. Specifically, as can be seen in the first graph, Spain's local market (MeffRepo) is showing encouraging signs, especially over the last few months.

Another distinctive feature in the repo market's performance is the substantial change occurring in the type of operations. The second graph shows that, in the years prior to the crisis, 90% of repos were bilateral, involving significant counterparty risk. The rest of the operations were carried out via an intermediary (generally a third bank) that looked after the collateral and transferred the funds, a situation that reduced but did not entirely eliminate counterparty risk. As a result of the financial crisis, a considerable proportion of bilateral repos started to be carried out via clearing houses, operations called cleared or CCP repos. The preliminary findings of the quarterly survey carried out by the ECB and the Money Market Contact Group revealed that cleared repos currently account for more than 60% of operations. This sharp growth recorded by CCP repos is due to the fact that, should the borrower default, the clearing house takes on its commitments.

Tags

European Central Bank (ECB)
Euro area