Margins and Haircuts: Limits to Leverage and Potential Unintended Consequences

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Evaluating Macroprudential Tools

Panel Discussion by:

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*The ideas and opinions expressed are the speaker's alone and should not be interpreted as reflecting the views of the Board of Governors of the Federal Reserve System nor its staff.

- Reiterating two key messages from Governor Tarullo's remarks, macroprudential policy should endeavor to….

    1. Reduce the likelihood that a large financial institution threatens financial stability

    2. Develop measures to deal with leverage and run risk in markets not fully contained in universe of PR firms

- How does the repo market relate to these objectives and how does the repo market relate to other similar markets that are undergoing significant regulatory changes to achieve these goals?

- The repo market provides levered exposure to financial assets. Other markets like derivative markets do this too.

- Repo markets are very large and provide a significant amount of leverage to the financial sector
    - The repo market is not at all an "interbank market" that only serves the needs of banks
    - The repo market links cash providers to banks and securities dealers that in turn provide leverage to hedge funds and other vehicles seeking levered exposure to assets
    - While the repo market is typically described as the quintessential "shadow banking market" it is important to recognize that, by and large, the banking sector provides the oxygen to sustain this shadow banking market
    - As an example, as of Q3 2014, mortgage REITs are engaged in 250BN in Agency repo – most being provided by banks
    - It is not difficult to see how instability of EITHER a large repo lender or a large repo borrower could EITHER threaten financial stability or accelerate run like dynamics in the financial system

- What is repo financing? In 2010 16% of repo financed "risk collateral". In 2014 19% of repo financed "risk collateral". In the specific case of equity collateral, in 2010 repo was financing **75BN**. In 2014 repo is financing **160BN**!!

- How is the regulation and oversight of repo markets responding in the wake of the financial crisis?
- Derivative markets are undergoing significant regulatory reform that is informed by the two goals described above.
- Repo markets have undergone some voluntary reform in the tri-party space, e.g. intraday credit, and transparency has improved in the tri-party space but reform aimed at reducing run risk and moderating leverage is behind derivative market reform
  - Some banking reforms such as LCR and leverage ratios are having an influence on the repo market
- Uncleared derivatives: US, Europe and Japan have all proposed specific rules to require initial margin on most derivatives
- Uncleared repo/SFT: FSB has published a margin proposal - no concrete proposals have been made at the national level
- High level comparison of FSB repo proposal and Uncleared margin proposals is informative

Margin Requirements	FSB Repo/SFT Proposal	Uncleared Derivatives
Govt Collateral Subject?	No	Yes
Banks/Dealers Subject?	No	Yes
Margin Level (equity)*	6%	15%

- While the repo and derivative markets are distinct and exhibit important institutional differences we should be mindful of the incentives created by widely varying regulatory regimes

- An important consideration in financial market regulation is the potential for disparate regulatory treatment to exacerbate financial stress conditions once a risk event is crystalized

- In isolation each set of reforms makes each market safer but the interplay between different markets will depend on the relative degree of regulation in each market and not the absolute level of regulation

- Relatively advantageous regulation in one market could incentivize a build-up of activity in that market relative to others.

- In the event of a period of financial stress the institutional infrastructure of a single market may be stressed considerably more than would be the case if the same activity were more evenly spread out among a number of separate markets and infrastructures

- In considering the broad framework for financial market regulation, regulators must consider the financial system holistically and must consider the incentive effects that result from the full set of reforms within and across markets.