

Collateral demand in wholesale funding markets

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*Usual disclaimer applies.

What the paper is about

- ▶ Analyse the interaction between *funding demand* and *collateral demand* on the repo market.

More specifically,

- ▶ What drives firms' demand for collateral?
- ▶ How is funding demand affected by collateral demand?
- ▶ What are the policy implications?

Main findings

- ▶ Collateral demand impedes repo market functioning
- ▶ Funding and collateral demand are **positively correlated** across firms
- ▶ This is due to hedge funds speculative behaviour ...
- ▶ ... and mainly, to banks and dealers managing the IRR

Methodology Data

- ▶ Describe the empirical facts
- ▶ Build a model of repo trading
- ▶ Estimate the model
- ▶ Highly granular transaction data of repo trading backed by UK government bonds, from January 2017 to March 2023.

Results

- ▶ Collateral demand co-moves closely with forward implied volatility in the secondary bond market
- ▶ Funding demand closely follows the UK monetary policy rate
- ▶ Collateral demand is particularly important at times of heightened financial stress
- ▶ Dealers, banks and hedge funds have high collateral demand, whereas MMF, mutual funds and pension funds have low collateral demand.
- ▶ Collateral demand predicts future changes in bond prices - Hedge funds collateral demand predicts a fall in bond prices, implying that they use repos to speculate.

Some comments

- ▶ Drivers of collateral demand - Speculation, Hedging, Leverage, Convenience
- ▶ Dealers and banks are the largest majority in terms of trading share (ca 77 percent)
- ▶ Most of the short selling is then done for hedging IRR at times of increased financial stress
- ▶ Short-selling is a strategy to hedge against rising interest rates - in line with your approach?
- ▶ Comparing repo specialness costs with price risk of unhedged exposures may be a way of disentangling speculative from hedging behavior.

Some comments

- ▶ Specialness correlates positively with the DMO auction cycle: it increases over time, until the demand for on-the-run has reached its max.
- ▶ On-tap issuance tends to have a lower average level of specialness. The scarcity value will be less.
- ▶ On-tap issuance is higher for short-term bonds - the collateral demand is affected by the composition of the DMO debt
- ▶ Other factors that affect specialness are long term patterns of DMO supply and liquidity risks
- ▶ Repos at different maturities - ON specialness should be highest if hedging is the driving factor
- ▶ Primary dealers vs. dealers vs. banks