Towards A Sustainable Repo Market

Gerard Denham, Senior Vice President, Funding & Financing Business Development at Eurex, outlines the latest developments in sustainable finance, the role of the repo market and the progress of the Eurex Repo Green Bond General Collateral Baskets

Sustainable finance has been a prominent and intensive focus for financial markets over the past 18 months owing to increasing demand from investors for ESG-compliant investment opportunities, as well as the coordinated and concentrated attention on this subject by policy makers and regulators. This focus has been particularly intense in Europe.

Governments, as well as many of the world's largest asset managers, pension funds, banks and insurance companies, have declared their intentions to agree to a range of net-zero emissions initiatives, as well as sustainable finance regulatory directives, by adopting multiple schemes and treaties that will culminate in the COP26 Summit — the

26th UN Climate Change Conference of the Parties in Glasgow, hosted by the UK Government in November 2021.

This year's summit is expected to reveal a proliferation in sustainable finance initiatives, as governments seek to demonstrate their climate leadership credentials before the world.

Green Bond and Sovereign Issuance

The sustainable debt market (Green, Social and Sustainability bonds, or GSS) reached a cumulative US$1.7 trillion at the end of 2020, with almost 10,000 instruments issued under GSS labels since 2006. This current critical decade has begun with labelled issuance evolving into the mainstream. US$700 billion worth of GSS instruments were issued in the calendar year 2020, almost double the 2019 figure of US$358 billion, indicating the intensive growth in sustainable debt despite the impact of the Covid-19 global pandemic.

Sustainable finance is a focus of national and supranational governance alike, with Europe exceeding a cumulative US$500 billion of green bond issuance at the end of April 2021, according to Climate Bonds Market Intelligence.

The European Union (EU) is committed to climate-neutrality by 2050, and the response from governments and corporates suggests that sustainable finance is growing in strategic significance. The EU plans to ringfence almost a third of its sizable pandemic recovery programme for green investments, as the European Commission continues to work on defining its green economic activity.

National governments in Europe are also making strides — 2021 has seen Italy go to the sustainable finance market with an inaugural sovereign green bond while Spain, Denmark and the UK have all signaled intentions to follow suit. Italy became the tenth sovereign issuer in Europe, with a record-breaking green bond issuance.

The German and French bond markets have both been supported by issuance from their national governments. Germany's green bond debut arrived late last year, alongside vanilla equivalents, with its innovative 'twin bond' model — from which green yield curves can be recorded and used as a reference point for companies and other nations looking to tap the European bond markets. In May this year, Germany issued a further series of twin bonds, this time extending the yield curve out to 30 years.

The Covid-19 global pandemic has provided a renewed incentive to position environmental considerations at the centre of global recovery and resilience programmes. The EU will safeguard up to €250 billion of a €800 billion Coronavirus recovery package for green investments over the next five years with its 'NextGenerationEU'.

This is the new temporary recovery instrument at the heart of the EU response and aims to support the economic recovery and build a greener, more digital and more resilient future. To finance the NextGenerationEU, the European Commission, on behalf of the EU, will borrow on the capital markets. This activity will be concentrated between mid-2021 and 2026 and repaid by 2058.

The Commission seeks to raise 30 per cent of the funds, amounting up to €250 billion in current prices, through the issuance of NextGenerationEU green bonds and to use the proceeds to finance green policies, while simultaneously boosting the size of the green bond market and inspiring more issuers to issue green bonds.

The EU has also been working to create a landmark classification system for green investments. The EU Taxonomy, and subsequent EU Green Bond Standard, aim to establish a catalogue of environmentally sustainable economic activities to supplement investment into sustainable infrastructure to meet the EU's European Green Deal targets.

View from the repo market

Eurex Repo launched its green bond GC basket in November 2020. The green bond basket encompasses Euro-denominated fixed income securities that are issued in accordance with certain guidelines that include renewable energy, preservation of biodiversity, sustainable waste management and other sustainability-related criteria.

On the sell side, bank treasury desks have an environmental, social and governance (ESG) focus and are strong supporters of new green bond issuance. Meanwhile, the buy side has already demonstrated that they are at the forefront of sustainable finance within the financial industry. The new Eurex Repo green bond general collateral (GC) basket is a useful component for the overall buy-side strategy as it offers repo market participants the opportunity to manage their short-term cash (i.e. money market positions) in an ESG and green bond-compliant way.

Eurex Repo initially started with a single basket for green bonds which includes government as well as non-government bonds. The green bond GC basket encompasses euro-denominated debt securities that observe the guidelines and principles for green bonds.

In an extensive client consultation period with repo market participants, sustainable finance initiatives are a top priority for all clients but this has not yet resulted in a distinct mandate regarding repo transactions. Feedback specified that adequate supply of liquid collateral is key to support any sustainable finance initiative and the use of green bonds as the collateral in a repo transaction was a key requirement.

The consultation indicated that repo market participants are willing to contribute and participate in market-led sustainable finance working groups and consultation forums to achieve the goal of a sustainable repo market.

In the longer term, there is the potential to introduce green bond baskets for the Eurex GC Pooling market once the green bond repo market becomes more established in terms of liquidity. Eurex has the flexibility to supplement the product range with more specialised GC baskets based on developing client demand — by potentially including other sustainable finance bond types such as social bonds and sustainable bonds.

The green bond GC basket was designed to meet demand from both buy- and sell-side clients with strong ESG mandates and has really kicked off the discussion regarding sustainable finance in the repo market.

As a result of the Eurex Repo client consultation, two new green bond GC baskets will become available for trading on Eurex Repo's F7 trading platform in July. One basket will feature higher credit quality, ECB eligible, government and supranational issued green bonds with a maturity date not exceeding 10 years.

The second new basket will contain the same features, except the maturity date will not have a restriction. This basket will enable repo market participants to transact in the longer-dated 30-year green bond issues, such as the recent issues by the German Finance Agency.

ICMA and the ERCC discussion paper

The International Capital Market Association's (ICMA) European Repo Collateral Council (ERCC) issued a discussion paper in May 2021 entitled Green and Sustainable Finance: What is the role of the Repo Market? The paper highlights the role of repo in green and sustainable finance, exploring the sustainability aspects of repo and collateral.

The paper identifies different possible intersections between the repo and collateral market and sustainable finance: repo with green and sustainable collateral; repo with green and sustainable cash proceeds; and repo between green and sustainable counterparties.

The ERCC envisions a green repo market where buyers and sellers would only transfer bonds that are classified as green, such as the green bond GC basket launched by Eurex, which acts as a short-term funding vehicle for green assets.

One of the key functions of the repo market is to support liquidity in the secondary market and facilitate price discovery. While evolving regulatory initiatives and central bank policy measures will be important to encourage investment in, and mobilisation of, sustainable assets, repo has a key role to play in the growth of sustainable assets such as green bonds, social bonds, sustainability-linked bonds.

Segments such as green bonds still lack secondary market liquidity for some of the reasons mentioned in the ICMA paper. Use cases which involve collateral baskets with a sustainability focus include investors (or trading agents acting on their behalf) lending cash against securities that investors can report as meeting their sustainability policies and objectives (e.g. an inclusive approach to fund green bonds) in their investment disclosures .

Aside from any 'value-based' considerations, other risk-based criteria (evolving around credit risk) should apply such as collateral haircuts, concentrations and exclusions managed by tri-party collateral agents.

Eurex Repo offers centrally-cleared repos with green and sustainable collateral. The bonds included in the Eurex Repo green bond GC basket are subject to Eurex Clearing eligibility and follow the ICMA Green Bonds Principles.

Other sustainable finance bond classifications such as social bonds and sustainable bonds can be included in additional collateral baskets based on sustainable finance themes, given appropriate consultation with market participants, data vendors, and market infrastructure providers.

A sustainable repo transaction could also be based upon an index of sustainable collateral for cash management purposes (i.e. the cash leg of a repo transaction could be aligned to an index based on green, social, sustainable and sustainability-linked bonds classified under the ICMA's respective guidelines and principles).

Additionally, there is potential for repo collateral to be based upon the upcoming EU Green Bond Standard linked to the EU Taxonomy criteria and the UN Sustainable Development Goals (SDGs).

The most important aspect of the Eurex Repo green bond GC basket, and other potential service offerings, is to ensure its role in supporting liquidity and collateral fluidity and to contribute to the development of an efficient and transparent sustainable finance market.

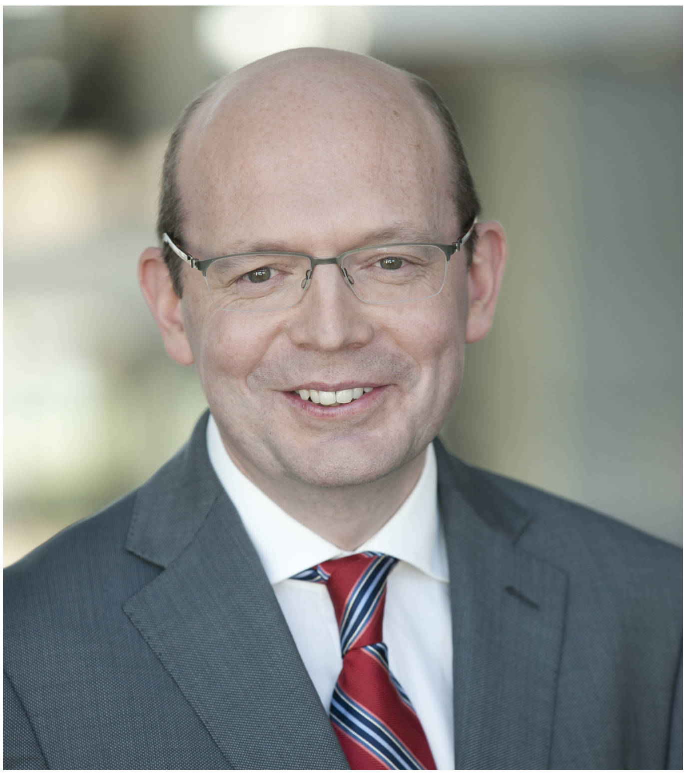
Collateral eligibility and collateral quality will still be determined by market participants and assisted by the subsequent infrastructure providers such as exchanges (for bond listings), data providers, rating agencies, second party opinion providers, trading platforms, central counterparties, ICSDs, tri-party collateral agents and trade repositories.

It is also the role of market participants and market infrastructure to continue to support issuance and liquidity across all asset classes (i.e. green and non-green), while the transition to a more prominent level of sustainable finance is accomplished.

The role of all repo market participants is to promote and strengthen issuance in the primary market and support liquidity in the secondary market. There is undoubtedly potential to embrace the concept of green and sustainable finance more actively in repo markets. Trade associations may also consider supporting any potential regulation intended to ensure that the repo and collateral market plays a central role in the overall development of sustainable finance.

Additional consideration could be given by policymakers and regulators to supporting the repo and collateral market's role in the overall development of sustainable finance. For example, this might include the introduction of prudential regulation that is risk-based to ensure there is an increased allocation of sustainable assets as outlined by the EU (or equivalent) Taxonomy.

The responsibility is now with repo and collateral market participants to promote a robust and sustainable repo and collateral market and, in doing so, to support transition towards a sustainable global economy.



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