Gaining a Competitive Edge: Government Bonds, Collateral and Regional Economic Growth

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Governments have natural incentives to support collateral transactions using local currency bonds

- Collateralized short-term funding drives sovereign debt demand, which in turn lowers funding cost
- Lower borrowing costs across the domestic financial system typically mean more predictable domestic growth
- This relationship can be traced through data and economic theory
- Collateral can be based on long-term or short-term debt issuance
- Collateralized transactions are one of many inputs to government debt demand
Capital markets have expected transmission channels through the real economy

- Cash lenders accept government bond collateral
- More liquidity for government bonds
- Improved economic activity
- More financial transactions
- Tighter spreads and lower borrowing costs
Government bond bid-offer spreads support stable funding markets and macroeconomic policy

Government bond bid-ask spreads, 2019
(Basis points)

Sources: Asian Bonds Online, Federal Reserve Bank of New York, Finadium analysis

The US repo market is 52X larger than the Fed Funds unsecured market

Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, Vietnam, UST 10 year
Source of demand: government bonds used as collateral for OTC derivatives margin

**OTC derivatives requirement**
- Agreement made to conduct an OTC derivatives transaction
- End-users have a variety of commercial, hedging and investment requirements for engaging in OTC derivatives, for example an Interest Rate or Total Return Swap

**UMR rules**
- Initial and Variation Margin must be delivered to support the transactions under Uncleared Margin Rules
- Initial Margin must be eligible collateral: government bonds are often used
- Variation Margin is in cash

**ISDA CSA**
- ISDA Credit Support Annexes (CSA) can allow local government bonds
- By agreement with both counterparties

**Clients**
- Clients can hold local debt issues without having to source outside collateral
- No portfolio drag from collateral transformation costs or holding low value assets
ISDA’s 2019 Margin Survey found US$442 billion in posted Initial Margin

Initial Margin received by the 20 largest market participants by type

- **Cash**, 0, 0%
- **Other securities**, US$71bn, 16%
- **Government securities**, US$371bn, 84%

Source: ISDA Margin Survey Year-End 2019
Source of demand: local currency repo markets drive collateral utilization

Asian repo outstanding by country, 2019
Total: US$3.1 trillion

- China: 56%
- Japan: 36%
- Korea: 2%
- Australia: 3%
- Hong Kong: 0%
- Thailand: 2%
- Other: 1%

Source: Finadium, "Local Currency Repo in Asia: Collateral Growth and the Path to Mass Adoption"
What happens in a repo transaction

Start

Collateral (bonds) ($1)

Collateral provider  →  Cash provider

Cash value of collateral minus haircut ($0.98)

Cash borrowed plus interest (rate)

End

Collateral provider  →  Cash provider

Collateral (bonds) ($1)

Can be structured as a sell/buy-back or as a cash loan with pledged collateral
The use of bond collateral boosts financial stability compared to unsecured financing

- Collateralized transactions provide two-sided protection to investors in case of default
- Securities can be bankruptcy-remote as opposed to cash that may sit on a counterparty’s balance sheet
- Collateral is transparent and risk can be measured
- Collateral can bring financial stability benefits when combined with appropriate macro-prudential regulation
An argument for collateral is an argument for regional development

- A greater use of Asian regional sovereign debt as collateral in financial transactions encourages demand for these assets
- Greater demand drives reduced bid-offer spreads, which in turn lowers borrowing cost
- OTC derivatives and repo are two sources of collateral demand
- The importance of collateral markets is analogous to cash bond and FX markets
- National governments can help by encouraging collateral usage in domestic and regional transactions
- The same principle can apply to domestic collateral demand and regional collateral baskets
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