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LCH: Liquidity access and systemic risk: A clear path for non-bank financial institutions

Over the last two decades, the importance of non-bank financial institutions (NBFIs) has increased significantly, as their assets now represent almost 50% of total global financial assets, according to the Financial Stability Board.[1] These increasingly important participants play a critical role in the financial ecosystem and particularly in the European Government Bond market by facilitating its secondary market, acting as a risk warehouse for such underlyings. However, this evolution is also raising questions that need to be addressed to ensure stability of the overall financial ecosystem.

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The leverage used by a number of these NBFIs to execute their strategies, combined with more complicated access to liquidity in periods of stress, results in a higher risk of default that could spread to the market, turning an idiosyncratic problem into a more systemic one.

This article highlights the NBFI relationship with banks in respect of intermediation pressures (Balance Sheet and Risk Weighted Assets (RWA)) and the key role that central counterparties (CCPs) play in alleviating them, and the consequential benefits to NFBIs.

1. NBFIs – Liquidity risk

The new paradigm: All together now

Until very recently, discussions around NBFIs were mainly concentrated on hedge funds but other NBFIs are also exposed to liquidity strains, which can occur when the ability for investors to withdraw their investments or liquidity via their usual channels is reduced.

Theoretically, a peer-to-peer market could efficiently manage the liquidity transmission problem, but such a market is unlikely to develop, as many NBFIs cannot always face another NBFI due to regulatory and/or internal risk management constraints (counterparty credit risk). Moreover, unlike in the US, European NBFIs are often trading on different maturities, which requires banks to do the maturity transformation.

Bank capacity

In Europe, currently NBFIs cannot easily access central bank money directly. As a result, their liquidity access often comes in the form of repurchase agreements executed with bank intermediaries. In normal market conditions, this reliance on banks is sustainable and minimises market frictions. In stressed conditions, however, a bank's capacity can stretch quickly and translate into either haircut spikes or, even worse, the removal of liquidity access when it is most needed.

Moreover, as of today, the bilateral repo market trades at or near zero haircut, which adds further pressure on the dealer as the absence of haircut is ultimately reverberated into the bank Credit Risk RWA.

Deleveraging

In an extreme but plausible scenario, deleveraging would be the only available means to access liquidity for certain NBFIs. But deleveraging in a stressed market, as observed during the Liability Driven Investment (LDI) crisis, would also

exacerbate the stress (e.g. underlying asset price de-pegging, a higher haircut being imposed and the flight to quality).

This 'vicious cycle' would, at some point, spread across markets and to other market players, endangering the stability of the whole financial system.

Consequently, NBFI vulnerabilities leading to a systemic risk are now under scrutiny and providing reliable liquidity access for NBFIs is a growing regulatory priority.

2. Regulatory focus

Lessons learnt

The 2022 LDI crisis is a recent reminder that market players are not immune to shocks, although they are much better prepared than in the past.

Thanks to the quick intervention of the Bank of England and brokers/dealers absorbing some of the cost impact, the shock was quickly contained and repo rates returned to their pre- 'mini budget' levels in short order.

At the same time, Central Banks have enhanced their liquidity toolboxes and clarified their role as 'Lender of Last Resort', but such micro-prudential toolboxes won't be effective without a macro-prudential approach that tackles liquidity risk management.[2]

This is even more significant considering taxpayer money could be put at risk at a time when economies are struggling to recover their growth.

Regulatory considerations

International bodies and local regulators[3,4] have all acknowledged the potential contagion risk that could arise from NBFIs' vulnerabilities. In view of this, the SEC adopted rules imposing mandatory clearing for cash and repo transactions on US treasury securities, while in Europe, a forward-looking framework is being devised.

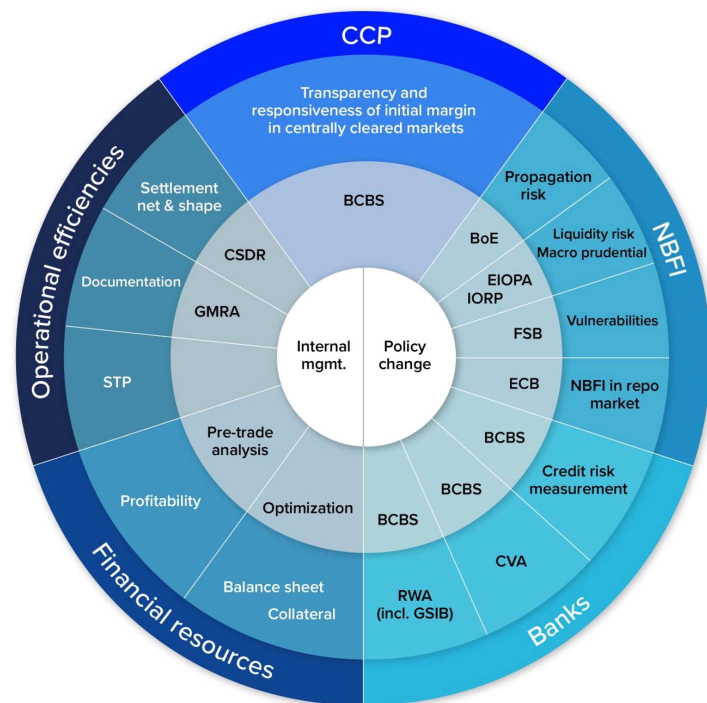
The approach is a holistic one, as it tackles both the measurement of the risk at entity level but also at a system-wide level (the Bank of England has already updated its System Wide Exploratory scenario (SWES)). Other policies being considered by regulators include:

"Liquidity and maturity transformation are at the core of liquidity risks, which means that indicators of these vulnerabilities should be an integral part of the monitoring framework. […]

Binding balance sheet constraints on financial intermediaries can amplify the severity of liquidity stress as it propagates through the system. […] Measurement of systemic liquidity risks needs to capture not only liquidity vulnerabilities at the level of entities or market but also stress transmission and amplification."

Systemic Liquidity Risk: a monitoring framework – European Systemic Risk Board – February 2025

Figure 1:



- Leverage measurement for NBFIs

As of today, only banks are constrained on their leverage ratio impacting their intermediation capacity unless wider netting is achieved

- Stress testing, including default of the main liquidity provider

In case of the default of its main liquidity provider during period of stress, agreeing and documenting a new Global Master Repurchase Agreement (GMRA) with another provider might not be achievable

- Haircut and margin framework

This would reduce potential losses in case of the default of the counterparty and act as a discerning criterion for leverage strategy

- Encouraging wider central clearing

By increasing intermediation capacity and handling counterparty credit risk in a unified manner, central clearing can buffer, up to a level, the deleveraging risk and its spreading

While each measure benefits overall financial stability, decisions will need to acknowledge the trade-off between the benefits and the impact on liquidity, market infrastructure and other dynamics.

The potential impact on all market players of ongoing reflections from regulatory bodies is shown in the chart above (Figure 1).

3. Central clearing

Access to liquidity

One of the main advantages of central clearing is the deep, stable and reliable access to liquidity it provides. More than 100 financial institutions across Europe, Asia and North America, provide close to €1.5trn equivalent in funding or assets daily at LCH RepoClear. While crises might reduce liquidity in the uncleared space, over the last five years, stressed events have persistently led to more volume in the CCP, making it a safe harbour in times of crisis.

Netting benefits

By allowing NBFIs, broker dealers and central banks/Debt Management Offices to meet via its different membership models in a single secured place, the CCP facilitates the management of banks' financial resources, and particularly their balance sheet constraints. As a result, the CCP enables banks to offer more intermediation capacity to NBFIs, reducing the risk of limiting NBFIs' access to liquidity.

Margin benefits

While CCP margins are often initially considered a cost, they also have their virtues. Primarily, and if the right balance between mutualisation (default fund) and bilateral margin (initial margin) is met, margins protect the members in the case of default of another participant. Similarly, by isolating common products within the same default fund, a CCP can limit spillover effects and help stabilise the market.

Additionally, the application of margin on transactions can help reduce the leverage taken by some entities, which in turn makes the overall ecosystem more stable.

The right product

Because liquidity risk can stem from the inability to mobilise the right collateral, in the right place, at the right time, it is important for a CCP to provide a wide range of solutions for its members. This takes the form of:

- Different products

If the repo market is largely dominated by government bonds (RepoClear Special), it is also interesting for members to access liquidity by repoing a wider variety of their bond stock. The LCH €GCPlus product enables access to cleared, secured Euro cash funding through standardised baskets of a variety of ECB-eligible collateral debt securities.

Positions on the basket can be netted against positions on single government bonds (under netting eligibility criteria), optimising the margin requirements. Moreover, the availability of the basket to settle in both CSDs and iCSDs allows efficient balance sheet netting.

Finally, the recourse to GC can also be beneficial for intermediation, as it helps manage the exposure of the netting set through the calculation of the gross exposure.

- Different trading and settlement solutions

Because flexibility is key in times of stress, it is in LCH's DNA to support open access.

Offering a large scope of trading venues is reducing members' dependency on one market access point, while ensuring that all entities can leverage their preferred solutions.

The availability of multiple settlement solutions gives members the assurance that they will be able to mobilise their assets when needed, with minimal frictions and constraints.

Conclusion

NBFI entities have become major players in the financial system. Therefore, their operating model, structures and behaviour are more scrutinised than ever. The risk arising from their trading activity is also attracting regulators' interest, with a clear objective of ensuring that financial stability is not at risk. In this context, the SEC will adopt rules imposing mandatory clearing for cash and repo transactions on US treasury securities, starting in 2026 for cash transactions. While we are not there yet in Europe, it seems legitimate for market participants to analyse the opportunities and suggest some potential ways for the market to evolve.

By facilitating access to a deep pool of liquidity, enabling banks to optimise their financial resources and strengthening the risk framework applied to repo transactions, and participating in controlling overall leverage in the market, central clearing is evolving from a nice-to-have, to a must-have solution for a significant number of NBFIs.

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