ICMA EUROPEAN REPO COUNCIL

Financial Stability Board
Centralbahnplatz 2
CH-4002 Basel
Switzerland

22 May 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: FSB Shadow Banking Workstream – Interim Report on Securities Lending and Repos

Introduction:

On behalf of the European Repo Council ("ERC") of the International Capital Market Association ("ICMA"), the purpose of this letter is to provide feedback primarily concerning the repo oriented aspects of the Financial Stability Board's (FSB's) 27 April 2012 Shadow Banking Workstream Interim Report on Securities Lending and Repos. The ERC notes that the FSB has invited comments on this report, in particular on the issues arising from the securities lending and repo markets which it identifies as potentially posing risks to financial stability. The ERC further notes that these same financial stability issues will form the basis for the next stage of the Workstream's work, which is to develop appropriate policy measures to address risks, where necessary, by the end of 2012.

The repo market is one of the largest and most active sectors in today's money markets. It provides an efficient source of money market funding for financial intermediaries while providing a secure home for liquid investments. Repo is also used by central banks as their principal tool in open market operations to control short-term interest rates. Repos are attractive as a monetary policy instrument because they carry a low credit risk while serving as a flexible instrument for liquidity management, which benefits the functioning of financial markets. Central banks are also able to act swiftly as lenders of last resort (and have done) during periods of market turbulence by way of the repo market.[1] In a repo transaction securities are exchanged for cash with an agreement to repurchase the securities at a future date. The transaction is collateralised, with the cash securing the seller's securities and the securities securing the buyer's cash. Collateral and netting are key to the proper functioning of repo markets. In the event of default, the collateral can be sold and exposure to the defaulting party can be netted off.

[1] The ERC has published a White Paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This paper sets out in greater detail what the repo market is and its benefits and is available via the ICMA website at http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx.

The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of practitioners in this market, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. A short ICMA ERC position paper "Building and sustaining the European Repo Market", which briefly examines ICMA ERC's past and present work, is appended to this response letter.

Commentary:

Whilst there are many elements being considered in the examination of Shadow Banking, the ERC is primarily focused on those aspects that bear most directly on repo. Given that the Interim Report comes from the FSB's Shadow Banking Workstream on Securities Lending and Repos, much of its content is of direct significance to the ERC.

A. Principal remarks

The ERC notes that the Interim Report has reviewed current market practices through discussions with market participants, and classified the markets into four main, inter-linked segments; and that the Interim Report goes on to identify those aspects of securities financing markets which the Workstream views as constituting potentially important elements of the shadow banking system, as defined by the FSB. In addition, the ERC notes that from its review of market practices and regulatory frameworks, the Workstream has preliminarily identified seven issues arising from the securities financing markets that might pose risks to financial stability and/or need further investigation by the Workstream. These financial stability issues will consequently form the basis for the next stage of the Workstream's work, which is to develop appropriate policy measures to address risks, where necessary, by the end of 2012.

The ERC has been actively engaging in support of these FSB efforts and remains committed to the continuance of this engagement. The ERC believes that there is significant benefit in a globally coherent approach and is keen to see that the FSB's work in this area can be sufficiently well delivered that allied efforts, such as those currently being advanced by the European Commission, will remain informed by and closely aligned with what the FSB is already doing.

Recognising that shadow banking is currently the subject of scrutiny by regulators and that the repo product is part of this process, the ERC identified the need to seek to ensure that policy-makers (a) understand how repo and repo market works and (b) recognise the role repo plays in traditional banking, as well as in supporting the efficiency and stability of the financial system. The ERC therefore commissioned two studies, both written by Richard Comotto of the ICMA Centre. The first of these "Haircuts and initial margins in the repo market", which was published in February 2012[2], questions the popular view of the role played by collateral haircuts in the recent crisis. The second "Shadow banking and repo", which was published in March 2012[3], refers to the former and elaborates on a number of other key points about the repo market in context of the shadow banking debate. The ERC considers that both of these papers are essential contributions to the current consideration of repos and their role in shadow banking, and accordingly the ERC requests that these two papers be reviewed thoroughly and treated as fully integral elements of this response letter.

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2 http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts and initial margins in the repo market_8 Feb 2012.pdf

3 http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Shadow-banking-and-repo-20-March-2012.pdf

As already described in the introduction above, the repo market is one of the largest and most active sectors in today's money markets, providing an efficient source of money market funding and an essential tool for use by central banks. In case regulatory measures are adopted which curtail this vital source of funding there will be consequent impacts on economic activity as market users are forced to fall back on other limited sources of funds.

One measure which the ERC perceives could act in such a way would be the imposition of mandatory minimum haircuts. The ERC wishes to make quite clear that it is not intrinsically against the use of haircuts. Indeed ERC members routinely utilise haircuts, as required by the application of their respective risk management frameworks. The imposition of mandatory haircuts would, however, be a significantly different matter. Accordingly the ERC respectfully requests that any such step not be taken until there has been full and careful consideration, including open discussions amongst users of repo markets, including central banks, the regulatory authorities and any other appropriate parties. The details of this ERC response highlight many questions pertinent to such a debate, which include, for instance, that haircuts protect one party, typically the buyer, but in so doing they expose the other party to an unsecured credit risk.

Additionally the ERC wishes to make clear that the focus of its concerns relate to the fixed income market, which importantly will be the source of the bulk of the collateral for the many purposes for which it will be required. The demands for collateral are developing significantly, in consequence of other major actions which are underway to help rebuild a safe and sound financial system following the turmoil of recent times. Within the G20 agenda, increased collateral use is stipulated through the promotion of central counterparty (CCP) clearing for standardised OTC contracts, improved risk management of residual OTC activity and new bank liquidity buffer requirements. The achievement of these goals will be ill served if constraints on the operation of the repo market impair its ability to efficiently mobilise suitable fixed income collateral to meet these needs.

Notwithstanding the ERC's primary focus on fixed income collateral, which covers a wide range of products – not only government bonds, but also corporate bonds, ABS/MBS and even unsecured bank loans (credit claims), the ERC recognises that there are other important collateral types, including equities, gold and ETFs, which, subject to various degrees of liquidity adjustment, also have potentially valuable roles to play.

B. The Interim Report's description of four market segments

The Interim Report divides the securities financing markets into four main, inter-linked segments: (i) a securities lending segment; (ii) a leveraged investment fund financing and securities borrowing segment; (iii) an inter-dealer repo segment; and (iv) a repo financing segment.

We note that inter-dealer market is being characterised as an overnight CCP market, while the repo financing market is seen as a term triparty market. We consider the real situation is more complex than this, with the inter-dealer segment not being entirely CCP-cleared or overnight. Further, the repo financing segment is not entirely a triparty market in Europe and in the US much triparty can be inter-dealer. More importantly, however, we emphasise that the share of government bond collateral is almost 80% in Europe and the percentage of the remainder represented by ABS and other structured securities was small even before the crisis.

(As a minor point, we are surprised by the apparently small figure (last sentence on page 3 of the Interim Report) for the estimated US repo market size.)

C. The Interim Report's five key drivers of the markets

The Interim Report identifies five key drivers of the securities lending and repo markets that contribute to better understanding of the characteristics and developments of the four market segments.

In section 2.3 of this section of the Interim Report it is stated that "...short selling may have the effect of temporarily re-directing cash intended for investment in equity or bond markets into the money markets, creating additional demand for wholesale "money-like" assets…", but we find it difficult to follow the logic of this argument. The proceeds of the short sale are given by a party buying an equity or bond like any other investor. Short selling is therefore just a temporary redistribution of securities between investors (ultimately, from the party who sells to the short-seller when he closes out his short position and to the counterparty to the short sale).

D. The Interim Report's overview of regulations for securities lending and repos

The ERC applauds the efforts which the FSB has made to examine current regulations for securities lending and repos, which are reported on in section 4 of the Interim Report. This is an important exercise in helping both to identify possible regulatory approaches and to understand where there may be regulatory gaps. The ERC also considers that it is important to carefully consider the effect of other regulatory changes which are underway, many of which already bear upon shadow banking in a variety of ways. The ERC notes the European Commission's helpful attempt to consider this, as reflected in section 6 of its 19 March 2012 Green Paper on Shadow Banking.

There are many and complex interactions between the different existing and incoming regulations, adding to the challenge of reasonably assessing the extent to which further regulation may be necessary to address shadow banking concerns. The ERC notes that one important example of new regulations is the leverage limit being introduced as part of the Basel III package of measures. This may prove to have a marked effect upon the procyclicality of the financial system, which could meaningfully alter the extent of incremental concerns about the possible specific contribution of repo to leverage and procyclicality. Hence the ERC considers that, whilst there may indeed be regulatory gaps appropriately needing to be addressed, moves to further directly regulate the repo market need to be subjected to continued open debate and thorough impact assessment.

E. Observations on the Interim Report's seven financial stability risk issues

The Interim Report identifies seven "issues arising from the securities financing markets that might pose risks to financial stability and/or need further investigation by the Workstream". In an annex to this response letter we have laid out each of these issues in turn, together with the ERC's applicable more detailed observations.

Concluding remarks:

The ERC appreciate the valuable contribution made by the FSB's examination of the issues articulated in this Interim Report and would like to thank the FSB for its careful consideration of the repo oriented points made in this response. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,

Godfried De Vidts
Chairman
ICMA European Repo Council

cc :	*Andrew Hauser,*	*Head of Sterling Markets Division, Markets, Bank of England;*
	Daniela Russo,	*Director General, DG Payments & Market Infrastructure, European Central Bank;*
	Nadia Calviño,	*Deputy Director-General, DG Internal Market and Services, European Commission;*
	Emil Paulis,	*Head of Directorate G, Financial Markets, DG Internal Market and Services, European Commission;*
	Patrick Pearson,	*Head of Directorate G2, Financial Markets Infrastructure, DG Internal Market and Services, European Commission;*
	Mario Nava,	*Head of Directorate H (acting), Financial Institutions, DG Internal Market and Services, European Commission;*
	David Wright,	*Secretary General, International Organization of Securities Commissions;*
	ICMA European Repo Committee	

Annex

ERC Observations:

regarding the Interim Report's seven "issues arising from the securities financing markets that might pose risks to financial stability and/or need further investigation by the Workstream"

i) Lack of transparency

Questions have been raised about the transparency of repo. These doubts seem to have arisen from Lehman's Repo 105 and MF Global's repo-to-maturity, which some commentators appear to have mistakenly assumed represent the standard method of accounting for repo. In fact, the standard accounting treatment is to retain the collateral on the balance sheet of the seller to reflect the fact that, because the seller commits to repurchase the collateral at a fixed repurchase price, he retains the risk and return on that collateral. Helpfully, because a cash asset and corresponding repayment liability are added to the seller's balance sheet, this will expand to indicate increased leverage.

Another concern about the lack of transparency of repo arises from the impact such transactions have on the quality of the seller's assets. But this is not an issue specific to repo. Rather, it is about general balance sheet transparency. If greater balance sheet transparency is deemed necessary, assets will need to be categorised in terms of credit and liquidity risk. It would be relatively straightforward to categorise holdings of assets in terms of credit risk by using credit ratings. In terms of liquidity risk, it would seem logical and most efficient to use the proposed regulatory liquidity ratio framework (Liquidity Coverage Ratio and Net Stable Funding Ratio) to classify assets.

In addition to concern over the transparency of repo on a firm's balance sheet, there is also an issue about repo market transparency. However, there is a wide range of statistics already available, including (as quoted in the Interim Report) the semi-annual ICMA survey of the European repo market. The problem is that the sources are disparate and inconsistent. In the US, systematic disclosure requirements on short-term funding arrangements are being introduced. Greater disclosure may be helpful for both regulators and the market. But the extent of disclosure needs to be carefully considered, so that the regulatory value of the information gathered justifies the cost of reporting.

In Europe, the idea of a repo trade repository has been mooted. This would be no small undertaking. The repo market has a similar transaction frequency to FX but each repo requires far more data to be captured. The repository would also have to be very flexible, as there is a wide range of repo contract variants and alternative legal constructions. A thorough cost-benefit analysis is merited.

These points are more fully covered in section #9, "The transparency of repo", in the recently published paper "Shadow banking and repo[4]", as compiled by Richard Comotto.

ii) Procyclicality of system leverage and interconnectedness

The ERC are particularly concerned by the credence that many parties to the shadow banking debate appear to be attributing to the, so called, "Run on Repo", as postulated by Gorton and Metrick[5]. These concerns are mentioned in the aforementioned paper "Shadow banking and repo" (in particular we draw attention to section #6, "Does repo amplify pro-cyclicality?"), but are also the subject of a separate, specific February 2012 research paper by Richard Comotto "Haircuts and initial margins in the repo market[6]".

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[4] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Shadow-banking-and-repo-20-March-2012.pdf

[5] Gorton, Gary, & Andrew Metrick, Securitized Banking and the Run on Repo, 9 November 2010

[6] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts and initial margins in the repo market_8 Feb 2012.pdf

The ERC believe that this latter paper, which also highlights other supportive research, raises sufficiently compelling doubt to warrant very careful re-examination of the risks purportedly posed by repos. Any consequent policy proposals ought only to be formulated in light of such re-examination having been rigorously completed.

Besides this overarching expression of concern, we have the following more specific observations prompted by the particular text of this section of the Interim Report:

(Page 15, S5.2). The sensitivity of access to credit to the creditworthiness of the borrower is not unique to repo and should not be addressed by repo-specific measures, as this would introduce risk and price distortions into the market.

(Page 15, S5.2.1). The proposed scenario is: the quality of a class of collateral deteriorates and becomes ineligible, causing a contraction in securities financing, which damages underlying cash market liquidity, reducing the availability of reliable prices for collateral valuation, triggering a vicious circle. We consider that the sequence of cause and effect in this proposed vicious circle is the wrong way round. It is not that ineligibility as collateral in the repo market damages cash market liquidity. An asset will become ineligible as collateral after that asset has become too difficult to value in the cash market (i.e. the repo market responds to cash market problems). The repo market is not the venue where asset prices are formed. Moreover, if a class of asset has become ineligible as collateral, pricing problems would become irrelevant for the repo market. But in any event, it is the cause of the initial shock that needs to be considered. The collapse in the prices of US housing or some European government bonds could not have been prevented or even halted by obstructing the free working of the market. These problems have to be tackled at a more fundamental level (i.e. causes not symptoms).

However, there is a suggestion implicit in the discussion that regulators wish to use the repo market to absorb (i.e. not fully transmit) exogenous shocks to the financial system. The preferred tool would seem to be a deep minimum mandatory haircut, the aim of which would seem to be to make secured lenders indifferent to cash market prices during the initial phase of a crisis. The drawbacks to such a proposal have been highlighted previously by Mr Comotto: (1) market data and qualitative analyses of the crisis by bodies such as the CGFS and the US Taskforce on Triparty Repo Market Infrastructure clearly show that big changes in haircuts were not significantly widespread to have had a systemic impact; (2) haircuts of credible magnitude would suck an enormous volume of liquidity from the market, causing serious financing difficulties for the financial system as a whole, as well as raising the price and reducing the liquidity of the underlying securities; (3) the idea of introducing such haircuts to head off a crisis risks being a self-fulfilling prophecy; (4) the idea of introducing such haircuts as a macroprudential lever to be activated at the top of a cycle, not only risks being a self-fulfilling prophecy, but would also be incredibly difficult to calibrate; (5) such haircuts would be too crude to reflect the variation in the risk/return characteristics of underlying securities, hence they would therefore distort relative pricing and market activity; (6) deep mandatory haircuts on collateral would artificially reduce the price differential between secured and unsecured funding, potentially and perversely making riskier unsecured funding relatively more attractive; (7) mandatory haircuts would fail to stop the withdrawal of credit in a crisis, as lenders would resort to other defences such as the reduction of credit lines and the contraction of terms – the capacity to absorb exogenous shocks is better created at firm level, through the use of capital and liquidity buffers; and (8) if collateral prices fall below even the mandatory haircut, there will be a massive “cliff effect” – in effect, the haircut might simply dam up trouble, which then breaks all at once.

(Page 16. S5.2.2). We are encouraged by the language of the Interim Report, which suggests to us that some of the arguments in the aforementioned paper "Haircuts and initial margins in the repo market" have indeed received consideration. In addition to the drawbacks concerning the idea of mandatory haircuts elaborated in the previous section, we note:

(1) changes in haircuts are only a potential problem when transactions are rolled over frequently, e.g. for overnight repos. In the European market, one-day transactions are estimated to constitute less than 20% of the market. Hence, we believe that in case mandatory minimum haircuts are to be considered, they should be limited to very short-term repos. We suggest that term transactions would benefit more from improved efficiency of margin maintenance, which is less likely to have destabilising effects on market liquidity. As the Interim Report notes, haircuts reflect the expected delay between the last successive margin call before a default and the final sale of collateral, which can be many days. In contrast, the rates of change of margin calls will be more gradual because margin calls only compensate for daily price changes and not deteriorations in market liquidity;

(2) haircuts pose their own problems, e.g. an automatic exposure on the borrower and an element of encumbrance. We consider that it can be argued that they should be abandoned in favour of more realistic pricing. After all, a market price should reflect the liquidation value of an asset. A haircut should really be unnecessary, particularly where there is efficient margin maintenance; and

(3) the Interim Report warns about over-optimistic haircuts, prompting us to wonder if, perhaps, the backtesting of haircuts should be an operational risk management requirement.

We highlight that the ERC is already proactively promoting improvements in efficient margin maintenance, as more fully described in the final paragraph of this annex (under point "vii)" below). As repo markets will largely manage the overall use of collateral, endorsement of this "improved" approach should be of significant assistance to market stability, given which the ERC believes that there will be even less possible need for any mandatory haircuts regime.

(Page 16. S5.2.3). The fall in collateral velocity highlighted by the IMF's Mr Manmohan Singh was in large part triggered by the misuse of re-hypothecation by Lehman's.

iii) Other potential financial stability issues associated with collateral re-use

The fact that collateral funding may be re-used appears to be articulated in a way which implies this is bad, or at least dangerous. In fact this may not be bad at all and the danger may lie in such churning ceasing to occur. We note that in unsecured funding markets the same funds may similarly pass along chains of intermediaries and be recycled (obviously without any haircut at all) many times – pre-crisis this was the way much liquidity circulated in the financial markets, including very significant amounts of interbank funding.

Markets and regulators have quite correctly realised that reliance on unsecured funding is unsafe and behaviour has adjusted accordingly. Collateralised funding offers a safer alternative (as routinely practised by central banks), without which there would be a dramatic drying up of liquidity in global financial markets. Hence we consider that there is a need for significant caution before adopting any policy proposals which might lessen the velocity of collateral.

The ERC wish to stress the fact that re-use and re-hypothecation are not synonymous. Re-hypothecation is a term that applies to pledging. Pledgors are said to hypothecate collateral to pledgees. Typically, the pledgee cannot use the collateral as the pledgor retains legal ownership. Re-hypothecation is a special case where the pledgor gives specific permission for the pledgee to use the collateral and is usually limited to financial assets. Nevertheless, the pledgor retains a security interest in the collateral. In repo (under the GMRA) there is sale, with full title transfer. Since no security interest is retained the security sold in the opening leg of the repo may be freely reused by the purchaser, as is the case with any other asset which he owns. This of course does not negate the fact that the purchaser has any obligation to resell when the date of the closing leg of the repo is reached; and must cover this obligation accordingly.

We also note that the operational risks of re-hypothecation have caused concern, but this does not apply to reuse. We appreciate that re-hypothecation is also worrying regulators because of leverage and interconnectedness and that re-use does carry the same risks, but in our view there are still important differences. Re-hypothecation is less transparent (because there is no sale) and it is, in some ways additional leverage, whereas re-use is often part of market liquidity management.

Besides these concerns about the potential impact of any measures to limit re-use, we have the following more specific observations prompted by the particular text of this section (page 17. S5.3) of the Interim Report:

Potential for greater interconnectedness. We believe that there is a need for greater specificity about the problems which regulators perceive as being created by interconnectedness. Is the need to address (1) the opacity that might be created a complex system; (2) interconnectedness as a symptom of regulatory arbitrage; or (3) network instability? We consider that opacity should be addressed by disclosure measures; regulatory arbitrage is being addressed by ensuring that regulated firms cannot shift activities outside the regulatory perimeter; and network instability is highly abstract and theoretical. The ERC highlight that greater connectivity is a function of specialisation, which is a force for greater market efficiency. We consider that regulators therefore need to be cautious about seeking to reduce interconnectedness, if indeed this is at all practicable. The alternative would seem to be greater market concentration, which brings its own set of problems.

Potential for higher leverage. It appears to us that this may be a reference to the idea that collateralised funding can be leveraged infinitely, e.g. a repo bond may be used to raise cash, this cash may then be used to buy another bond, a repo of that bond can raise more cash to buy more bonds and so on. In our view (1) collateralised financing should allow higher leverage inasmuch as collateralisation reduces the risk per dollar of lending; (2) lenders will impose limits on the leverage they permit borrowers even where lending is collateralised – we believe that Lehman's use of Repo 105 suggests that the problem is one of transparency about a borrower's aggregate leverage; and (3) the idea that collateral allows infinite leverage misunderstands the nature of collateral. Because collateral is imperfect (it has legal and operational risks), there may be unexpected losses when it has to be liquidated in a default. Collateral is therefore only a credit risk mitigant. The primary risk to the lender remains the counterparty credit risk and collateralised funding does not remove the need for the usual credit risk management processes. Responsible repo users will not therefore allow the offer of good collateral to remove objections to lending to poor counterparties, but they will lend more to good counterparties.

Possible problems in a default by multiple firms which have repoed out the same (re-used) collateral. The ERC consider that this question reveals a misunderstanding of the default process in repo, as laid out in the GMRA and other legal agreements. To illustrate, assume A has repoed out a bond to B, who has repoed out the same bond to C, who has repoed out the same bond to D. So, B and C have repoed out a re-used bond. D now has a bond that was originally owned by A and which should be returned to A at the maturity of all the repos. But assume B and C default. A will close out and set-off its obligations to and from B. D will do the same to C. The liquidators for B and C will do the same with each other. A will retain the cash it has borrowed from B (up to the value at the time of default of the bond it repoed to B) to try to buy back its bond. D will sell the bond to try to recover the cash it has lent to C. This process worked successfully in the Lehman default at the height of the crisis.

In respect of this section of the Interim Report we also draw attention to section #7, "The potential of repo for excessive leverage", in the above referenced paper "Shadow banking and repo".

iv) Potential risks arising from fire-sale of collateral assets

The ERC note that the issues here appear to be: the danger of a market impact for holders of large concentrations of a particular asset, the risk that a fire sale will put pressure on other firms holding that asset (contagion) and the difficulty, even for prudent collateral-takers, to know the aggregate use of that asset as collateral by particular borrowers. The ERC observes that there are systemic risk factors, which are in fact inherent in any market for transferable assets. The question is how to mitigate such systemic liquidity risk. We believe that systemic risks require systemic responses. In this case, the authorities can be expected to intervene as lenders of last resort to ensure the liquidity of the system as a whole. For their part, market users should be expected to remain creditworthy and to have liquidity buffers sufficient to sustain themselves until official intervention restores sufficient liquidity to obviate the need for fire sales. Measures to improve credit risk management, as well as to enhance capital and liquidity buffers, are already in place or in prospect. We consider that alternative ideas such as embedding circuit-breakers into the market microstructure would fail, because they would just store up selling pressure and at the cost of artificial market disruption.

Furthermore the ERC wishes to point out that, similar to market practise in the unsecured market segment, individual limits exist for counterparties not just in isolation, but rather alongside of other internal risk limits established within each bank. Hence the concentration of risk on a particular asset is largely constrained by each individual financial institution. What has been an eye-opener is the non-existence of such asset class limits for sovereign bonds, which were effectively being considered to be "fail proof". Hence the ERC is supportive of recent remarks by Ms Sharon Bowles (MEP) that regulators ought to reconsider the ill-conceived idea that sovereign bonds are risk free. As identified in our overall response collateral used in repo transactions largely depends on the cash market valuation of such underlying assets. The ERC therefore consider it misguided to attribute concern about the fire-sale of collateral assets to the repo markets, as it should rather be part of regulatory scrutiny regarding why cash bond fire-sales happened. These are reflections of the overall investment community, who have to increase their liquidity responsive to any deterioration in the credit quality of their asset holdings – even in the case of government bonds.

So, in the normal case, repo markets follow the cash markets levels for daily pricing and thus ought not to be perceived as the cause of fire-sales. It is only in those very few cases of an actual counterparty default where the repo market is itself the source of such sudden sales of received collateral securities, which then happen as a logical consequence of the legal and robust framework established and maintained by the GMRA (full details of which may be obtained from ICMA).

v) Potential risks arising from agent lender practices

As the ERC's specific focus is the repo market, we will leave it for others, particularly including the International Securities Lending Association (ISLA), to comment on this securities lending focussed topic.

vi) Securities lending cash collateral reinvestment

As with point (v) above, the ERC will leave it for ISLA and others to comment on this securities lending focussed topic.

vii) Insufficient rigour in collateral valuation and management practices

The ERC observe that this section of the Interim Report refers specifically to MBS collateral and notes the infrequency of marking-to-market and overoptimistic pricing models, which delayed the realisation of losses on collateral, ultimately causing greater disruption.

The ERC strongly and pro-actively support the case for improved marking-to-market and margining. In September 2005 the ERC published its recommendations for a "Best Practice Guide to Repo Margining". This document has just been revised to ensure that it correctly reflects the ERC's view of current best market practice. In particular this revision includes enhanced recommendations regarding the taking of margin against open repos, ensuring that exposures are fully margined until actually settled. The ERC is actively promoting this updated set of recommendation across the international repo market and will take steps to review progress towards its broad adoption by market participants. Through this specific example and other similar efforts to support the development of best market practice, the ERC continues to evidence its pursuit of the application of rigorous practices in the international repo market. The ERC expects that a by-product of the adoption of this enhanced repo margin guideline will be an increase in same day (T+0) settlement of margin calls. We consider that improved settlement infrastructure, alongside such a move to T+0 settlement, would also be of huge benefit to better margining.

Appendix

Background paper outlining the ERC's past and present work

ICMA EUROPEAN REPO COUNCIL

Building and Sustaining the European Repo Market

A position paper prepared by the

European Repo Council

of the

International Capital Market Association

April 2012

This paper briefly examines the past and present work of ICMA's ERC.

Over the years the ERC has contributed to the establishment of a robust infrastructure to underpin the European repo market, including through the development of the Global Master Repurchase Agreement ("GMRA"). These efforts continue unabated, current initiatives including projects to enhance the available of high quality collateral and to boost collateral efficiency. Many current regulatory initiatives are of significance to the repo market and the ERC is actively participating in efforts to ensure that their objectives can be realised, whilst at the same time assuring the continued efficacy of the repo market.

Building and Sustaining the European Repo Market

Given the significant, on-going programme of regulatory reform, within which there is an increasingly crucial role which collateral will play, this is a particularly pertinent time at which to take stock of the work which the European Repo Council (ERC) of the International Capital Market Association (ICMA) has done over the years to contribute to the establishment of a robust infrastructure to underpin the European repo market.

Introduction

Since the early 1990's, ICMA has played a significant role in promoting the interests and activities of the international repo market, and of the product itself. The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of practitioners in this market, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. Membership of the ERC is open to ICMA members who transact repo business in Europe and the twice yearly ICMA ERC General Meetings are widely attended.

The ICMA ERC has become the industry representative body that has fashioned consensus solutions to the emerging, practical issues in a rapidly evolving marketplace, consolidating and codifying best market practice. The discussions that take place at the ERC meetings underpin the strong sense of community and common interest that characterises the professional repo market in Europe.

The ICMA ERC is also responsible for promoting the wider use of repo in Europe, particularly among banks, by providing education and market information. More information may be found on the ICMA ERC's website pages[7].

Documentation

ICMA has been and continues to be an active force in standardising repo documentation. The Global Master Repurchase Agreement (GMRA) is the most widely used standard documentation for the cross-border repo market. It is supported by associated legal opinions obtained by ICMA in more than 60 jurisdictions.

The most recent version of the Agreement, the GMRA 2011[8], is the result of a market driven process and wide consultation; it represents over a year's worth of detailed discussion and debate involving market participants and legal specialists.

Besides these formal legal underpinnings for the market, the ERC has promulgated a number of trading guidelines and recommendations[9]. These are developed in the overall interest of improving efficiency or liquidity in the market. This is an on-going process, with a new ERC recommendation on Repo matching as a driver for risk reduction having been published in July 2011; and an updated version of the 2005 Best Practice Guide to Repo Margining having been prepared for publication in the second quarter of 2012. Amongst ERC initiatives that are currently underway is a project to codify all these ad hoc documentation elements in a repo code of practice.

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[7] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/European-Repo-Council/

[8] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/global-master-repurchase-agreement-gmra-2011/

[9] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo0/

Education

Since the inception of its European Seminar in 1974, the ICMA has been committed to providing high quality ICMA Executive Education to its members and to the market at large. Supported by the ERC, this commitment is concretely extended in the repo market context through specialist courses on Securities Lending & Borrowing and on Collateral Management, as well as through targeted seminars providing market participants with the education they need in respect of the GMRA.

Transparency

The repo market is pivotal to other financial markets, particularly those in bonds and derivatives, as it is the main source of financing for dealers. Notwithstanding its importance, it was nevertheless hard to obtain figures on the size of the European repo market. In order to rectify this shortcoming, the ICMA ERC instigated surveys which have become the only authoritative source of data on the size and composition of the European repo market. These surveys are conducted by the ICMA Centre at the University of Reading in the UK.

For the most recent survey a sample of financial institutions in Europe were asked for the value of their repo contracts that were still outstanding at close of business on a single day in December 2011. Replies were received from 64 financial institutions, representing the majority of significant players in the European repo market. The results of this, the twenty-second semi-annual survey of the repo market in Europe set the baseline figure for market size at € 6,2 trillion. The results of all these surveys are publicly available[10].

Market efficiency

Over the years the ERC has contributed to many initiatives to improve market efficiency, both at its own instigation and in support of the efforts of others. This work stretches across the inter-linked areas of trading, clearing and settlement. Some of the examples of the ERC's own projects are reflected in the trading guidelines and recommendations discussed under documentation (above). Efforts in support of others have included prolonged involvement in market wide expert groups, such as the European Commission's CESAME and the ECB's COGESI.

A significant recent ERC contribution came with the July 2010 publication of published a White Paper[11] on the European repo market, including the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This White Paper emphasises the importance of the repo market for the efficiency and stability of the financial system. It was commissioned by the ERC in response to regulatory considerations which will impact the repo market; and given a perceived urgent need for action to remove the barriers to the efficient cross-border transfer of securities posed by the settlement infrastructure. The White Paper highlights infrastructure problems which have caused fails in the system in difficult market conditions and suggests solutions.

A December 2010 update set out responses to the ERC White Paper and described progress that had been made towards the elimination of barriers to interconnectivity; and a further March 2011 update sets out subsequent responses from the Greek authorities and the Italian CSDs.

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10 http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest/

11 http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/european-repo-market-white-paper-on-short-selling-and-settlement-failures/

Collateral initiatives

The importance of collateral has grown over many years, but has accelerated significantly since the advent of the financial crisis in mid-2007. This is in no small measure related to the shift in risk appetite of market participants, with an increased demand amongst them to secure their credit risk exposures through the taking of high quality collateral. Official policy makers have also significantly fuelled the demand for collateral as they have advanced steps to make markets more robust, to reduce systemic risk and help mitigate the risks of any future financial crises.

It is widely perceived that collateral demands will significantly outstrip supply, so it is essential that collateral be managed as a scarce resource. Given the competing demands that exist for the use of collateral assets, the management of collateral needs to encompass the deployment of optimisation techniques – to ensure that the available collateral is utilised as effectively and efficiently as possible.

With a view to improving the efficient utilisation of collateral, by bringing together separate pools of liquidity, the ERC are discussing triparty settlement interoperability between the ICSDs (and eventually CSDs). This effort has been relatively slow to progress but has recently gained greater traction as the focus on collateral intensifies the pressure to ensure that repo can properly perform its role as the provider of assets in the collateral market place. When realised, this project will ensure that liquidity/collateral can flow freely, independent of the location of the collateral.

At the same time the ERC is seeking to increase the supply of high quality collateral assets, by advancing a project to support the use of credit claims as acceptable bilateral repo market collateral. Credit claims, or bank loans, became fully recognised as collateral for transactions with central banks in the Eurosystem in January 2007, following their inclusion in the 'Single List'. In the current climate there is an increasing appetite for the extra financing flexibility that can be realised by extending the use of credit claims, so they can also be mobilised as possible collateral in bilateral repo market transactions.

More broadly, the ERC is supporting the ICMA's 2012 initiative in coordinating the Collateral Initiatives Coordination Forum[12] (CICF). Conceived as a joint trade associations' body, bringing together a broad range of representation from right across the financial industry, the CICF provides a channel for information sharing, education and joint endeavours in the field of collateral. An important measure of the success of the Forum will be ensuring that its work can effectively be channelled into applicable official sector projects, particularly including the collateral harmonisation project recently initiated under the auspices of the ECB's COGESI.

Regulation

Over the years the ERC has contributed to a wide range of regulatory debates, both through its participation in numerous meetings and through written submissions, in respect of consultation papers, regulatory proposals and other similar official papers. Many instances of the ERC's work in this regard are publicly available[13]. In performing its work in this area the ERC also seeks to produce papers at its own initiative, in order to better inform deliberations about necessary and appropriate regulatory interventions. The ERC repo market White Paper (see above) is one such example, as is a report on the role of central and commercial bank money in European clearing and settlement[14].

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12 http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/collateral-initiatives-coordination-forum/

13 http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/erc-contributions/

14 http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/European-repo-market-report/

Following from the financial crisis which commenced in mid-2007, there is an agreed need to enhance many aspects of financial market regulation. This has spawned a wave of EU regulatory initiatives, impacting all financial market participants, across product areas and through the transaction cycle (trading, clearing and settlement). These are at different stages of their evolution and many of the details remain to be resolved. Nevertheless, there is no doubt that this is a transformational regulatory programme, which includes many elements with significant bearing upon the repo market.

Repos consist of sales and repurchases, typically of high quality fixed income securities.

- The extension of the Markets in Financial Instruments Directive (MiFID) to encompass non-equities markets will bring new trading rules for fixed income. This will require far more trading to be conducted through organised venues and impose calibrated pre- and post-trading transparency requirements.
- Central counterparty (CCP) clearing activities are being regulated through the European Market Infrastructure Regulation (EMIR), with a thrust to maximise the use of CCP cleared, standardised market contracts as opposed to bilaterally cleared, bespoke over-the-counter (OTC) transactions. Whilst most of the focus is on the OTC derivatives market, other OTC markets will also be impacted. In the EU the ERC's repo survey shows that CCP clearing is already used for a meaningful proportion (estimates suggest this may be half of the volume) of repo trades.
- Securities settlement is to be regulated by the Central Securities Depository Regulation (CSDR), which will introduce both an authorisation regime and important market practice requirements. Standard settlement will be set at trade date + 2 days, whilst other measures will enforce market discipline by controlling and penalising the treatment of fails.
- Certain specific trading activities are also being directly regulated, as for example with certain short selling activities captured by the Short Selling Regulation (SSR).

Increased demand for collateral is also being driven by regulatory reforms, examples including:

- Basel requirements, to be translated in the EU through the Capital Requirements Regulation/Directive (CRR/D); introducing the holding of liquidity stress buffers – assets to satisfy these requirements comprise a short list of high-quality collateral;
- the shift of standardised OTC derivatives to CCP clearing, as required in the EU by EMIR, which will give rise to demands for significant amounts of initial margin (as well as some increase in variation margin amounts); and
- increased requirements to margin any bilateral OTC contracts (outside of CCP arrangements), incentivised by penal treatment of uncollateralised exposures in the CRR/D requirements.

For the ERC one other very significant element of the regulatory programme is the initiative to ensure the correct regulatory treatment of "shadow banking". The ERC has been closely engaging with the Financial Stability Board's (FSB's) applicable shadow banking workstream, led by the UK FSA's David Rule. The Interim Report of this workstream describes the securities lending and repo markets in overview; key drivers of these markets; their location within the shadow banking system; the existing regulatory framework in overview; and financial stability issues. The workstream is due to present its proposals for regulatory measures by the end of 2012. In parallel, the EU has its own shadow banking proposals under development by the European Commission. In context of this shadow banking debate, the ERC wishes to ensure that policy-makers understand how repo and repo markets works, and that they recognise the role repo plays in traditional banking, as well as in supporting the efficiency and stability of the financial system. It therefore commissioned two studies[15], the first on collateral haircuts, the latest on issues such as asset encumbrance and transparency.

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[15] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/shadow-banking-and-repo/

Summary of the ERC's position

For many years the ICMA ERC has contributed to the establishment and maintenance of a robust infrastructure to underpin the European repo market. It will continue to do so.

Underpinning this is the GMRA, which is the most widely used standard documentation for the cross-border repo market. It is supported by associated legal opinions obtained by ICMA in more than 60 jurisdictions.

Complementing this sound legal basis for repo activity, the ERC has promulgated a number of trading guidelines and recommendations developed in the overall interest of improving efficiency or liquidity in the market. This is an on-going process.

The ERC actively promotes high quality education, through its provision of specialist courses and targeted seminars.

To promote transparency the ERC instigated and maintains a twice yearly survey, which has become the only authoritative source of data on the size and composition of the European repo market.

The ERC actively promotes the enhanced efficiency of the European repo market, at its own initiative and in collaboration with other projects, including those led by the public sector.

The ERC White Paper produced in July 2010 and subsequently updated, provides a benchmark description of the European repo market and highlights specific needs for reform of the market infrastructure. Continued progress to close these gaps is an essential precursor for the establishment of an efficient EU single financial market.

Collateral demands will significantly outstrip supply, so it is essential that collateral be managed as a scarce resource. It is essential that the repo market is not hindered from fulfilling its role as the provider of assets in the collateral market place.

The ERC supports increased efficiency in the utilisation of collateral through the removal of barriers to the free flow of liquidity. The ERC project to establish triparty settlement interoperability between the ICSDs is an important example of this commitment.

The ERC supports the increased availability of high quality collateral assets. The ERC project to establish the safe utilisation of credit claims as collateral for bilateral repos is an important example of this commitment.

The ERC supports the establishment of a robust financial regulatory framework within which the repo market can operate safely and efficiently. As new regulations are being simultaneously established for trading, clearing and settlement, there is a greater need than ever to engage in close, open dialogue so that official objectives can be realised, whilst at the same time assuring the continued efficacy of the repo market.

The ERC has a vital role to play in relation to collateral initiatives. It actively contributes to these both within the private sector (e.g. via CICF) and in partnership with the official sector (e.g. via COGESI).

Any direct regulation of repo, as considered in context of work on shadow banking, must be based on a thorough examination of the way in which repo and the repo market works. The ERC proactively seeks to ensure the necessary information is available to make this possible.