ICMA
International Capital Market Association

ICMA EUROPEAN REPO COUNCIL

European Securities and Markets Authority (ESMA)
103, Rue de Grenelle
75007 Paris
France

19 March 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: ESMA Discussion Paper – "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories"

Introduction:

The purpose of this letter is to provide feedback on behalf of the International Capital Market Association's ("ICMA's") European Repo Council ("ERC"), concerning the repo oriented aspects of the ESMA Discussion Paper "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories", as published on 16 February.

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.

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 during periods of market turbulence by way of the repo market.[1]

[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.

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.

In the international market, the Global Master Repurchase Agreement (GMRA)[2] provides a robust legal framework for documenting repo transactions. Supervisory authorities recognise the effect of the GMRA netting provisions for regulatory capital and large exposure requirements provided, inter alia, that a reasoned legal opinion has been obtained to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would find that, where a counterparty fails owing to default, bankruptcy, liquidation or any other similar circumstance, the regulated firm's claims and obligations pursuant to the GMRA would be limited to a net sum under the law of the relevant jurisdiction(s), and meets certain other requirements. Against this background, ICMA obtains and annually updates legal opinions on the GMRA, currently from 62 jurisdictions worldwide, for the benefit of its members. These opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole.

Commentary:

The ERC notes that this discussion paper follows the structure of EMIR, with the first section focusing on OTC derivatives and in particular the clearing obligation, risk mitigation techniques for contracts not cleared by a CCP and exemptions to certain requirements. The second part focuses on CCP requirements, where a number of provisions need to be specified through technical standards. The third part deals with trade repositories and in particular the content and format of the information to be reported to trade repositories, the content of the application for registration to ESMA and the information to be made available to the relevant authorities.

The ERC also notes that for understandable reasons the discussions surrounding EMIR have been, and continue to be, underpinned by considerations relating to derivatives. Nevertheless the ERC is conscious that the framework established by EMIR has broader ramifications. Accordingly the ERC considers that, as ESMA advances its essential work to elaborate the technical details necessary to operationalise the EMIR legislative framework, it is vital to establish standards which, whilst being robust, retain adequate flexibility to allow calibration suited to the efficient operation of markets in different, non-derivative, asset classes.

In context of this overall concern, the ERC has the following brief observations in relation to a few of the specific questions laid out in the discussion paper.

Section III.I OTC Derivatives

The ERC notes the group of questions in this section, addressing such matters as the clearing obligation and risk mitigation for non-CCP cleared contracts. To the extent that similar principles may be applied in setting technical standards for non-derivative products, the ERC highlights the importance of carefully evaluating the ways in which adaption would be necessary to take due account of the specific characteristics of any such non-derivative products.

[2] The GMRA is the most extensively used cross border repo master agreement and has reduced the risks associated with previously poorly documented repo transactions.

Section III.II CCP Requirements

Q23: What are your views on the notion of liquidity fragmentation?

The ERC continuously works to improve the efficiency of financing liquidity provision in fixed income markets. It is important that, within a safe and secure operating framework, efficiency is not lost through liquidity fragmentation, so this is an important area for more work. Interoperability is one way in which potential liquidity fragmentation may be mitigated and the ERC notes that the concerns relating to the establishment of interoperability arrangements are subject to asset class specific considerations, with a clear distinction drawn between cash and derivative markets.

Q34: Are the criteria outlined above appropriate to ensure that the adequate percentage above 99 per cent is applied in CCP's margin models? Should a criteria based approach be complemented by an approach based on fixed percentages? If so, which percentages should be mandated and for which instruments?

The ERC consider that it is best to adopt a criteria based approach, rather than to set fixed percentages. This would retain full flexibility to apply the approach across assets classes. It would also allow greater flexibility to flex application over time, either in light of lessons learned through experience or responsive to changed conditions necessitating re-evaluation of appropriate margining requirements.

Q44: Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

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. At the same time 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.

Amongst examples of these increasing demands are:

- increased focus on covered bond issuance by banks, secured against high-quality mortgage pools, as against senior unsecured issuance;
- increased use of repo funding to finance assets, including in context of an increase in the use of central bank financing;
- Basel requirements, to be translated in the EU through the 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.

Whilst these examples are couched in their European context, equivalent pressures also exist across global markets.

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 ERC considers that the design of collateral requirements should be taken forward in a way which allows for flexible consideration of the broadest possible range of collateral assets. Naturally the leading consideration must be safety but it may well be that appropriate risk management procedures can be established to make possible the safe utilisation of many forms of collateral asset. No doubt this would to some extent be predicated upon the instigation of a suitably risk sensitive haircuts regime (see Q47 below).

Q47: Do you consider that the elements outlined above would rightly outline the framework for determining haircuts? Should ESMA consider other elements?

The ERC draws ESMA's attention to the paper "Haircuts and initial margins in the repo market", written by Richard Comotto of the ICMA Centre and published by ICMA on 8 February. Whist this paper does not focus on the setting of CCP margins, it quite clearly highlights that careful analysis is needed to support any conclusions regarding the extent to which margins play a significant part in procyclicality. Any measures to take into account the procyclicality of haircuts, as contemplated in paragraph 127 of ESMA's discussion paper, ought only to be determined on the basis of a clear understanding of the actual extent of any relationship and will need to be sensitive to differences across asset classes.

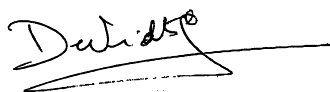
Section III.III Trade Repositories

The ERC notes that there are already some suggestions that the use of the trade repository concept should be extended to cover repo activity. This would be no small undertaking. The repo market has a similar transaction frequency to FX but each repo would require far more data to be captured. The reporting interface, database and analytical functions would also have to be very flexible, as there is a wide range of contract variants (from fixed-rate, through open and floating-rate, to structured repos) and legal constructions. A thorough cost-benefit analysis is clearly required before advancing any such proposal, including a thorough examination of alternative ways in which legitimate data transparency requirements may be satisfied.

Concluding remarks:

The ERC appreciate the valuable contribution made by the ESMA's examination of the issues articulated in this discussion paper and would like to thank ESMA 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 : ICMA European Repo Committee