ICMA EUROPEAN REPO COUNCIL

European Commission
Directorate-General for Taxation and Customs Union
Rue de Spa 3, Office 06/31
B-1049 Brussels

19 April 2011

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: European Commission Consultation Paper – Financial sector taxation

Introduction:

On behalf of the European Repo Council (ñERCò) of the International Capital Market Association (ñICMAò), the purpose of this letter is to provide feedback concerning the repo oriented aspects of the European Commissionôs 22 February 2011 consultation paper on financial sector taxation. The ERC notes that the purpose of this consultation is to gather input from all stakeholders in order to inform decisions on the applicable policy options.

The ERC was established by ICMA in December 1999, to represent the repo community in Europe. It is composed of practitioners in the repo field, 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 todayôs 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 sellerôs securities and the securities securing the buyerôs 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] In July 2010 the ERC 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, which sets out in greater detail what the repo market is and its benefits, is available, together with two subsequent supplementary Annexes, at https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx.

In the international market, the ICMA 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 which meets certain other requirements. Accordingly, ICMA obtains and annually updates legal opinions on the GMRA from 62 jurisdictions worldwide. 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:

Whilst there are many interesting issues discussed in this consultation paper, the ERC is for now going to restrict its focus to that aspect which bears most directly on repo. As the ERC sees it, this means that it should restrict its comments to answering consultation question #52.

Q52: Some authors argue that overnight secured credit (through repos mainly) necessitates special treatment of those types of funding because of the cheap, but unstable funding leading to systemic risk. Do you agree to such an argument and if so, what treatment do you suggest?

1. Yes, because _________
2. No, because _________
7. Cannot decide
8. Other _________

Please explain further and provide evidence, if you have any.

ERC response

The ERC refutes the suggestion that repo provides "unstable funding leading to systemic risk". On the contrary, repo is the instrument that provided an essential backstay to market liquidity during the crisis. Unsecured funding all but evaporated during the crisis, whereas the core repo market continued to function and also provided the platform for central bank support. Accordingly, regulators are placing collateralised markets like repo at the core of the reformed financial system.

Also, some claim that there were massive price collapses two days after Lehman's default caused by "front selling" of collateral by repo counterparties and an associated widening of spreads. However, the bulk of repo is collateralised with government bonds. There was no collapse in government bond prices following Lehman, rather there was a flight to quality. Spreads widened after Lehman primarily because of the spectre of further defaults by large institutions, not because of widespread selling of repo collateral.

The collateralised nature of repo facilitates liquidity management, reduces systemic risk and is used by market participants and central banks alike. Without the Global Master Repurchase Agreement providing a robust legal framework for this financial instrument, the current credit crisis would have been much more severe. Thanks to this framework (in practical, legal terms) established by market participants in full co-operation with the central banking community, emergency liquidity provisions have been possible in a secured lending environment, as encouraged by Basel II.

[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.

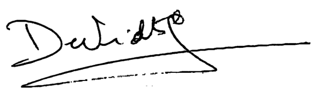
The ERC consider that taxing repo transactions would create unnecessary frictions, particularly as the margins are low. Even a little tax, which also may not necessarily be applied equally across the whole of the market, would jeopardise the product as it exists today. Since repo is the wholesale market funding tool, any such reduction in its liquidity would lead to an increase in systemic risk.

The ERC would like to make the point that all trading (financial or otherwise) is about transfers of risk. No risk implies no return. In financial markets, creditors can chose the degree of risk they take by varying their priority as a creditor and their position in the capital structure of the borrower. This is well understood and is essential in facilitating investment.

To obtain a clear picture of the evolution of the European repo market, we encourage you to review the semi-annual ICMA European repo market survey[3], which has now been published for a decade. For other accurate information regarding this product we also commend to you BearingPoint's "An analysis of the secured money market in the Euro zone", and Danny Corrigan & Natasha de Téran's "Collateral: securities lending, repo, OTC derivatives and the future of finance".

Concluding remarks:

In summary, repo is the core instrument for balancing the liquidity of a financial institution and as such brings more stability into the financial market. Accordingly a tax targeted at repo would be counterproductive. The ERC appreciate the valuable contribution made by the European Commission's examination of the issues articulated in this consultation paper and would like to thank the European Commission 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

[3] The ICMA European repo market surveys can be accessed from https://www.icmagroup.org/market_info/repo.aspx