ICMA
International Capital Market Association

# EUROPEAN REPO COUNCIL

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel,
Switzerland

16 April 2010

Dear Sirs,

**Response submission from the European Repo Council**

**Re: Basel Committee on Banking Supervision Consultation – "Strengthening the resilience of the banking sector"**

**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 Basel Committee's 17 December 2009 consultation papers – "Strengthening the resilience of the banking sector".

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 today's money markets and, as evidenced in the recent market turmoil, plays a critical role in liquidity provision for the financial system. 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. In repo transactions securities are exchanged for cash with an agreement to repurchase the securities at a future date. The securities serve as collateral for what is effectively a cash loan and, conversely, the cash serves as collateral for a securities loan. Collateral is key to the proper functioning of repo markets. In what is truly an international market, the world's unique global documentation for repo transactions is the GMRA[1].

[1] The Global Master Repurchase Agreement (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 notes that on 17 December consultative proposals to strengthen the resilience of the banking sector were announced by the Basel Committee[2]. The Basel Committee's consultative documents cover the following key areas:

- Raising the quality, consistency and transparency of the capital base;
- Strengthening the risk coverage of the capital framework;
- Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework;
- Introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress; and
- Introducing a global minimum liquidity standard for internationally active banks.

Whilst there are many interesting issues discussed in these Basel Committee consultation papers, the ERC is for now going to primarily restrict its focus to those aspects (summarised in Annexes 1 – 3) that bear most directly on repo. As the ERC sees it, there are therefore three pertinent sections of the consultation papers which the following paragraphs of ERC commentary address.

**1. *Counterparty credit risk***

As a general remark, the goal to improve the recognition and management of counterparty credit risk can only be encouraged. Nevertheless, the current regulatory review of the financial system should avoid inadvertently endangering what has been achieved so far. When the Basel Committee decided to upgrade the Basel 1 framework into Basel 2, adequate provisions were embedded to support migration from unsecured to secured lending practises. This was implemented in Europe and was in place as of the beginning of 2007. Its beneficial effects have been somewhat hidden because of other events; notably the use of a wide range of collateral without adequate daily pricing. The financial markets have lived through a period of excesses that need to be corrected, however, it would be unfortunate if these events brought into question market participants' ability to organise an adequate framework for well functioning repo markets. Best practice in this market has already been put in place to a large extent, with haircuts being used in various forms and eligibility sheets for collateral, as well as credit lines for counterparties which have to be validated by each bank's risk committees.

Banks are risk takers and the intense competition between banks provides a solid base for "cheap" credit to the real economy. Providing a regulatory framework with fixed haircuts (even by each underlying collateral type) may prove to be counterproductive to competition and have unintended consequences for the flows of liquidity between wholesale market participants. Thus it is quite right that haircuts should be responsive to risk and that the differential experience of securitisation exposures as against corporate debt should be reflected (the ERC notes however that even pre-crisis there was a rather limited market for repo of asset backed securities; and for the time being there is essentially no liquidity in that particular market segment). The ERC is however concerned that the recommendations of the Committee on the Global Financial System (CGFS), published in its 23 March report entitled "The role of margin requirements and haircuts in procyclicality[3]", contradict this principle of risk responsiveness and would be detrimental to the well being of the market.

In 2009 the G20, supported by EU Member States, advocated maximum use of CCPs. However, the repo market had established the use of CCP clearing in Europe as early as 1999 – when LCH Ltd, supported by market practitioners in the repo market, created Repoclear. This was followed by Clearnet (later merged into LCH.Clearnet group), Eurex Clearing and CC&G. The ERC firmly supports the use of CCP clearing in repo markets and continues to take steps to promote its development.

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[2] http://www.bis.org/press/p091217.htm

[3] http://www.bis.org/press/p100322.htm

The significant extensions of collateral requirements for OTC derivative exposures, both where these are moved to CCPs and for ongoing bi-lateral contracts - count amongst several contemplated measures that increase the demand for high quality collateral securities. Each such proposal needs to be developed on its merits, taking due account of the applicable risks. Nevertheless, the aggregate impact of proposals also calls for consideration. In case this aggregate impact becomes too great the outcome will be a market where the requisite collateral is inadequately liquid, leading to price distortions and the introduction of new risks – all of which may serve to undermine the very benefits which were sought.

CCPs are broadly accepted as a key tool in mitigation of counterparty credit risk in the OTC markets. Quite understandably the authorities are therefore pushing to make the fullest use of CCPs, whilst quite correctly appreciating that CCPs must themselves be subjected to very high risk management standards. If this latter aim is not adequately achieved the CCPs will themselves become a major source of risk. Given this public policy direction, it is an important component of the incentive structure that market participants should be able to rely upon CCPs and hence not have to treat their concentrated exposures to them in a way that would constrain their use – neither for capital adequacy nor for large exposure limit purposes. Any failure to adopt such an approach to the treatment of exposures to CCPs would undermine the incentive effect that is otherwise being pursued.

## 2. *Leverage*

As a general remark, the goal to improve the recognition and management of both leverage and capital adequacy can only be encouraged. The details of the way in which this is to be done will, however, have a significant bearing on the related views of the ERC. Much depends on the calibration of any leverage requirement and whether it becomes a hard limit or a monitored level requiring acceptable explanation of excesses. Assuming that the proposal will lead to a significant leverage limit the ERC are most concerned about the disallowance of repo netting.

The repo product has been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of the sort of market consistent documentation that the European Financial Markets Lawyers Group[4] now seeks to further promote. In the context of the GMRA 2000, the occurrence of an event of default has the effect of accelerating outstanding transactions and turning delivery obligations in respect of securities to cash sums based on default market value, then applying set off. A net sum will become due in favour of the party with the higher valuation for its transactions. The acceleration and conversion of obligations serves to reduce the risk of negative price movements in purchased securities following a default. The default market value is calculated by the non defaulting party in accordance with established principles which consider actual sale or purchase prices, market value quotations or fair market value as determined by the non defaulting party acting in good faith (GMRA 2000 para 10(e)).

The availability of netting is an important risk management tool, which has been carefully developed in the repo market over many years. It is only available in case significant conditions are satisfied; and is underpinned by legally robust arrangements – largely delivered through the GMRA and its supporting legal opinions. As has been demonstrated in practical examples, the correct exposure measurement in these cases is net rather than gross and it would consequentially be incorrect to require measurement on the gross basis. This is not a question of masking leverage, as has happened in certain cases where balance sheets have failed to fully reflect assets and liabilities, but rather recognition of the legal reality that the only exposure faced by the reporting entity is the applicable net amount.

The ERC's experience has been that the growth of repo has not been inspired by a desire to boost leverage, but rather as an important risk management tool, allowing lenders – rather than only having the ability to lend on an unsecured basis – to mitigate their risk by engaging in secured financing.

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[4] http://www.efmlg.org/home.htm

## 3. *Liquidity Ratios*

As a general remark, the goal to come to a more harmonised liquidity regulation can only be encouraged. On the other hand the proposal, as thus far elaborated, leaves plenty of room interpretation and debate. The ERC's view will depend significantly on further details, though they fully accept the idea that liquidity management needs to adjust to tighter rules - the implementation of which needs to find some proper balances.

These new liquidity risk standards will significantly impact funding. Much more emphasis is being placed on deposits & long-term funding, which are seen as "stable". A key question relates to the definition of liquidity. Far greater demands to hold high quality liquid assets as a buffer will arise and, in practice, Government securities will form a key component of bank liquidity buffers. These buffer holdings will tie-up significant volumes of such securities, such that overall both the cash and repo markets for Government securities will be significantly impacted – with a significant new risk of their liquidity being impaired. Furthermore, assets that are not considered highly liquid will attract increased costs as they cannot be counted in the liquidity reporting and longer term funding needs to be set against holding them.

ERC members have often discussed the appropriateness of the collateral to be used in the light of adequate liquidity of the underlying. Liquidity can be impacted by many influences and it is often the repo trader who has the clearest picture of a bond's liquidity. The use of government bonds will be part of the framework to fulfil calls for risk mitigation techniques, but there are real doubts this will be adequate to fulfil all needs, even with the current high issuance levels. In addition, such a narrow definition of liquid assets goes against the idea of portfolio diversification and could be sub-optimal in a crisis scenario, when all banks are trying to liquidate the same few government bonds. It is also naive to promote a system that implies all government bonds have equivalent liquidity value. At any given point in time certain bonds will prove less liquid, consequent on a variety of factors. Liquidity will also vary over time, especially if research indicating a long term decline in the credit worthiness of governments proves to be correct.

Non-government bonds that are part of central bank eligible programs provide a good potential alternative source of liquidity and could be included in the Basel liquidity buffer regime. However, the ERC recognises that the objectives which lead to the determination of central bank eligibility are not the same as those which underpin the proposed liquidity regime. The aim of the liquidity regime is to establish a pool of liquidity available without recourse to central bank funding, which will serve as the first line of defence in a liquidity crisis; with falling back on the use of central bank funds only becoming necessary in case the crisis proves worse than the stress scenario, leading to the available liquidity buffer becoming exhausted.

The proposed criteria to determine the liquidity value of assets are quite theoretical and extremely difficult to implement. More broadly, by focusing on the asset quality only, the Basel Committee is forgetting about market-infrastructure effects. Anonymous CCP trading and settlement systems linked to the Eurosystem have proven to enable a certain degree of liquidity to remain available. Accordingly the ERC proposes that the approach to the identification of "liquid assets" should proceed via a simple test: is the asset accepted as collateral for repos eligible for CCP clearing (by a CCP that fully conforms with the applicable standards promulgated by CPSS/IOSCO). In case of such assets the availability of repo through such robust infrastructure provides as good an assurance of liquidity as it is going to be possible to obtain. The necessary risk management controls and procedures that will be satisfied before an asset is accepted into such CCP clearing arrangements provide assurance with regards to the adequacy of liquidity, which will underpin market confidence. This equally provides a sound and objective basis for formulation of the regulatory approach. In the adoption of such an approach it would be necessary to accept that banks could prove their access to such liquidity either through their role as members of the applicable CCP or through their established, active contractual agreements with general clearing members.

Before closing, the ERC notes that a further point requiring attention in the design of this new regime will be the potential consequence for central bank refinancing operations. Demand for longer term repo operations should increase (at the expense of demand in shorter-term), as liquidity with maturities below 30 days will be of little value from a regulatory point of view.

**Closing Comments:**

The repo product has been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of market standard documentation.

The ERC believes that the interests of all parties are best served if provisions applicable to repos are as efficient and effective as possible. In case the effect of well intended new measures proves to be a reduction in the attractiveness of repo markets the consequence will be more risk, increasing financing costs and thereby harm to the economic position of end-users – be they market participants or central banks conducting their monetary policy operations. Moreover, the financial crisis highlighted the global scale of markets and their interconnectivity. The collateral analysis provided in the latest ICMA European repo market survey (conducted in December 2009[5]) shows that collateral is not limited to European countries. Almost 25% of collateral is from outside the European Union, evidencing that ERC members trade with counterparties on a global scale. Therefore any steps to be taken need to be considered and consistent at an international level. Nothing should be done that could lead to an undermining of confidence in the current legally robust framework for repos, since that could actually precipitate a worse crisis in the daily management of liquidity.

The ERC appreciate the valuable contribution made by the Basel Committee's examination of the issues articulated in these consultation paper and would like to thank the Basel Committee 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
European Repo Council

*CC : ICMA European Repo Committee*

5 https://www.icmagroup.org/ICMAGroup/files/59/59708fbd-0fcc-4838-bce8-0d29b4bc5586.pdf

***Annex 1 – Summary of key points noted from the Basel text re: Counterparty Credit Risk***

The consultative document presents proposals to strengthen the capital requirements for counterparty credit exposures arising from banks’ derivatives, repo and securities financing activities. These reforms will raise the capital buffers backing these exposures, reduce procyclicality and provide additional incentives to move OTC derivative contracts to central counterparties, thus helping reduce systemic risk across the financial system. They also provide incentives to strengthen the risk management of counterparty credit exposures. In particular the ERC notes that the proposal states:

- “In addition, since the crisis the valuation of securitisation exposures have become substantially more volatile than similarly rated corporate debt. The current supervisory haircuts method applies the same haircuts to repo-style transactions of securitisations and corporate debt of the same rating. This treatment no longer reflects the existing realities of the market and, for this reason, the Committee is proposing that a separate supervisory haircut category be implemented for securitisation exposures to better reflect the greater volatility of these instruments. As proposed, the new haircuts for securitisations would be double the supervisory haircuts applied to corporate debt. Furthermore, re-securitisations as recently defined in the securitisation framework would no longer be eligible collateral”;

- "Extend the margin period of risk to 20 days for OTC derivatives and securities financing transactions (SFTs) netting sets that are large (ie over 5,000 trades), have illiquid collateral, or represent hard-to-replace derivatives. The requirements would double the margin period of risk for netting sets which have recently experienced a material number of extended disputes”;

- "Increase the incentives to use CCPs for OTC derivatives and recognise that collateral and mark-to-market exposures to CCPs could have a zero percent risk weight if they comply with the stricter CPSS/IOSCO recommendations for CCPs,” and

- “Establish a high specific level of initial margin and on-going collateral posting requirements”.

***Annex 2 – Summary of key points noted from the Basel text re: Leverage***

The consultative proposal introduces a leverage ratio requirement, calculated in a comparable manner across jurisdictions, that is intended to achieve the following objectives:

- put a floor under the build-up of leverage in the banking sector, thus helping to mitigate the risk of the destabilising deleveraging processes which can damage the financial system and the economy; and
- introduce additional safeguards against model risk and measurement error by supplementing the risk based measure with a simple, transparent, independent measure of risk that is based on gross exposures.

In particular the proposal states:

- "The design of a leverage ratio requires a definition of capital (the capital measure) and a definition of total exposure (the total exposure or assets measure). The key elements of the Committee's proposal are listed below and summarised in the table in the Annex to this section."
  - "netting is not allowed (this applies to both regulatory and accounting netting for derivatives, repo style transactions and the netting of loans and deposits)";
- "Repo style transactions are a form of secured funding and therefore an important source of balance sheet leverage that should be included in the leverage ratio. The Committee proposes to include repo style transactions following the accounting measure of exposure but to disallow netting. By disallowing netting, the proposal deals with issues associated with international consistency in accounting standards, and also captures the leverage embedded in such transactions"; and
- "The Committee will also assess the impact of applying regulatory netting rules (based on the Basel II framework) as an alternative to the no-netting approach. This approach will also achieve international consistency."

***Annex 3 – Summary of key points noted from the Basel text re: Liquidity Ratios***

In the consultative proposals, two separate but complementary liquidity risk standards are advanced[6]:

- Liquidity Coverage Ratio

  This ratio identifies the amount of unencumbered, high quality liquid assets an institution holds that can be used to offset the net cash outflows it would encounter under an acute short-term stress scenario specified by supervisors. The specified scenario entails both institution-specific and systemic shocks built upon actual circumstances experienced in the global financial crisis. The scenario entails:

  - a significant downgrade of the institution's public credit rating;
  - a partial loss of deposits;
  - a loss of unsecured wholesale funding;
  - a significant increase in secured funding haircuts; and
  - increases in derivative collateral calls and substantial calls on contractual and non-contractual off-balance sheet exposures, including committed credit and liquidity facilities.

  As part of this metric, banks are also required to provide a list of contingent liabilities (both contractual and non-contractual) and their related triggers.

- Net Stable Funding Ratio (NSF)

  This ratio measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations. The standard requires a minimum amount of funding that is expected to be stable over a one year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.

  The NSF ratio is intended to promote longer-term structural funding of banks' balance sheets, off-balance sheet exposures and capital markets activities.

The scenario proposed for this standard entails a combined idiosyncratic and market-wide shock which would result in (inter alia):

- Loss of unsecured wholesale funding capacity and reductions of potential sources of secured funding on a term basis; and
- Loss of secured, short-term financing transactions for all but high quality liquid assets (active and sizable market: the asset should have active outright sale and repo markets at all times; market breadth and depth should be good)

Conversely in considering inflows

- Banks should assume that maturing reverse repurchase or securities lending agreements secured by liquid assets will be rolled-over and will not give rise to any cash inflows (0%); and
- Banks are expected NOT to roll-over maturing reverse repurchase or securities lending agreements secured by illiquid assets, so can assume to receive back 100% of the cash related to those agreements

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[6] On a related matter, it is noted that on 9 December the Committee of European Banking Supervisors (CEBS) published new guidelines on liquidity buffers and survival periods (available at http://www.c-ebs.org/News--Communications/Archive/2009/CEBS-Guidelines-on-Liquidity-Buffers.aspx). These new CEBS guidelines, intended for application by 30 June, consider applying stress scenarios, considering at least a one month survival period and one week requirements, in determining adequate liquidity buffers – to be comprised of cash and core assets that are both central bank eligible and highly liquid in private markets.

The numerator of the LCR is the "stock of high quality liquid assets". Under the proposed standard, banks must hold a stock of unencumbered, high quality liquid assets which is clearly sufficient to cover cumulative net cash outflows (as defined below) over a 30-day period under the prescribed stress scenario. In order to qualify as a "high-quality liquid asset", assets should be liquid in markets during a time of stress and, ideally, be central bank eligible. The Basel Committee consultation calls for assessment of "both a narrow definition of liquid assets comprised of cash, central bank reserves and high quality sovereign paper, as well as a somewhat broader definition which could also include a proportion of high quality corporate bonds and/or covered bonds".

*Characteristics of high quality liquid assets:*

Assets are considered to be high quality liquid assets if they can be easily and immediately converted into cash at little or no loss of value. The test of the "high quality" of assets is that by way of sale or secured borrowing, their liquidity-generating capacity is assumed to remain intact even in periods of severe idiosyncratic and market stress. An attempt by a bank to raise liquidity from lower quality assets under conditions of severe market stress would entail acceptance of a large fire-sale discount or haircut to compensate for high market risk.

- Fundamental characteristics
  - Low credit and market risk: assets which are less risky tend to have higher liquidity. On the credit risk front, high credit standing of the issuer and a low degree of subordination increases an asset's liquidity. On the market risk front, low duration, low volatility, low inflation risk and being denominated in a convertible currency with low foreign exchange rate risk all enhance an asset's liquidity;
  - Ease and certainty of valuation: an asset's liquidity increases if market participants are more likely to agree on its valuation. A liquid asset's pricing formula must be easy to calculate and not depend on strong assumptions. The inputs into those pricing formula must also be publicly available. In practice this should rule out the inclusion of any exotic product.
  - Low correlation with risky assets: the stock of high quality liquid assets should not be subject to wrong-way risk. Assets issued by financial firms, for instance, are more likely to be illiquid in times of liquidity stress in the banking sector.
  - Listed on a developed and recognised exchange market: being listed increases an asset's transparency.
- Market-related characteristics
  - Active and sizable market: the asset should have active outright sale and repo markets at all times (which means having a large number of market participants and a high trading volume). Market breadth (price impact per unit of liquidity) and market depth (units of the asset can be traded for a given price impact) should be good.
  - Presence of committed market makers: quotes will always be available for buying nd/or selling the asset.
  - Low market concentration: diverse group of buyers and sellers in an asset's market increases the reliability of its liquidity.
  - Flight to quality: historically, the market has shown tendencies to move into some types of assets in a systemic crisis.

The stock of high quality liquid assets should be comprised of assets which meet the characteristics outlined above. The following list describes the assets which meet these characteristics and can therefore be used as the stock of liquid assets:

(a) cash;

(b) central bank reserves, to the extent that they can be drawn down in times of stress

(c) Marketable securities representing claims on or guaranteed by sovereigns, central banks, non-central government public sector entities, the BIS, the IMF, the European Commission, or MDBs – as long as all the following criteria are met:

  (i) they are assigned a 0% risk-weight under the Basel II standardised approach; and

  (ii) deep repo-markets exist for these securities; and

  (iii) the securities are not issued by banks or other financial services entities.

(d) government or central bank debt issued in domestic currencies by the country in which the liquidity risk is being taken or the bank's home country.

In addition, the Committee will gather data on the following instruments – if included in the stock of liquid assets, these instruments would receive substantial haircuts, would comprise not more than 50% of the overall stock, and the portfolio would have to be diversified.

Corporate and covered bonds that satisfy all of the following conditions:

- Central bank eligibility;
- Not issued by a bank, investment or insurance firm;
- Low credit risk;
- Traded in large, deep and active markets; and
- Proven record as a reliable source of liquidity in the markets (repo and sale) even during stressed market conditions.

These assets must be unencumbered and freely available to the relevant group entities and should be managed with the clear and sole intent for use as a source of contingent funds. A bank should periodically monetise a proportion of the assets in its liquid assets buffer through repo or outright sale to the market in order to test the usability of the assets. Banks are expected to be able to meet their liquidity needs in each currency and maintain high quality liquid assets consistent with the distribution of their liquidity needs by currency.