ICMA

International Capital Market Association

ERC Annual General Meeting

January 18, 2012

Opening &
Update on recent developments

Godfried De Vidts, Chairman of the ERC

European Repo Council
Annual General Meeting

Luxembourg
18 January 2012

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Setting the scene…

- Tsunami of regulatory initiatives
- 40 Years in the financial markets….
- … we haven’t learned a thing!
- Verena Ross remarks at ICFR conference in Berlin
- … and what we have witnessed in the last 6 months

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Topics of interest

- FpML
- Cogesi – commercial v. central bank money study
- Eurosystem initiative re collateral procedures
- Collateral initiatives coordination forum (CICF)
- Credit Claims – final push

Topics of interest

- **LCR eligible basket for trading purposes**
- **FSB meeting**
- **ISIN Code progress**
- **ICMA MPC re settlement fails**
- **FTT – a bridge too far for repo markets**

Contacts

ERC AGM and ERC Committee meetings on website

Contacts and information:

http://www.icmagroup.org/About-ICMA/ICMA-Councils/European-Repo-Council.aspx

erc@icmagroup.org

Legal Update – ICMA GMRA related work

Lisa Cleary

GMRA related work

- Publication of the GMRA 2011
- GMRA 2011 Guidance Notes
- GMRA 2011 Annexes
- GMRA 2011 Protocol
- ICMA industry standard opinions on the GMRA
- ICMA legal opinion for Russia
- ICMA bespoke opinion service

Publication of GMRA 2011

- The Global Master Repurchase Agreement 2011 was published in May 2011.

- The GMRA 2011 is the result of a review process which considered various factors including lessons learned from the financial crisis, changes made to other standard master documentation and feedback from ICMA's ERC committee. The review focused on both commercial and practical considerations as well as legal and regulatory considerations.

GMRA 2011: Key amendments

- Definition of Event of Default- Act of Insolvency definition
- Method of calling an Event of Default
- Default valuation time
- Method of margin calculation- definition of Transaction Exposure
- Return of margin securities- Cash Equivalent Amount
- Set off

GMRA 2011 related documentation

- GMRA 2011 Guidance Notes
  - Assist users in completing the agreement and in arranging transactions under the agreement.
  - Summarise the key provisions of the agreement.

- GMRA 2011 Annexes
  - Buy/Sell back Annex
  - Bills Annex
  - Agency Annex
  - Equities Annex

GMRA 2011 Protocol: Upgrading

- 2011 Global Master Repurchase Agreement Protocol
  - Efficient and cost effective method of upgrading
  - Multilateral adherence
  - Upgraded default provisions
  - Transparency

2011 ICMA GMRA Legal Opinions

- In 2011 ICMA obtained opinions on the GMRA 1995, 2000 & 2011 in 62 jurisdictions.
- Opinions address enforceability of netting provisions and recharacterisation risk.
- Basic counterparty coverage (companies, banks and securities dealers) and extended counterparty coverage (also includes insurance companies, hedge funds and mutual funds).
- Opinions available at: http://www.icmagroup.org/legal

GMRA legal opinion for Russia

- In August 2011 amendments to the Russian legislation introducing requirements relating to the enforceability of close-out netting provisions (the "**Netting Provisions**") came into effect.

- In October 2011, FSFM drafted regulation setting out the list of associations and list of eligible cross-border master agreements for close-out netting purposes (the "**Draft Regulation**").

- Under the Draft Regulation (i) ICMA is recognised as a self-regulatory international body and (ii) the GMRA is considered applicable/eligible for netting in Russia (in case if one of the counterparties is non-resident).

- On 14 November 2011, FSFM published another draft regulation on the Procedure of Transactions Registration with Trade Repositories (the "**Repositories Regulations**") which is required for practical/procedural implementation of the Netting Provisions. This draft is subject to further comments/approvals from other regulatory bodies in Russia.

- The draft regulations <u>are not yet signed</u> but <u>are expected</u> to be adopted shortly.

GMRA bespoke opinion service

- In 2009 ICMA launched a new service whereby members of the **European Repo Council** may employ ICMA to co-ordinate the obtaining of bespoke opinions on a **cost sharing basis** with other members, outside of the annual legal opinion exercise.

GMRA bespoke opinion service

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Process

- **Step 1**
  - ICMA receive request from ERC member firm
  - ICMA contact local counsel in the relevant jurisdiction in order to assess whether a satisfactory opinion may be obtained and at what cost
- **Step 2**
  - If a satisfactory opinion can be obtained at an appropriate cost, ICMA will email the ERC council members inviting them to participate in the cost of obtaining the opinion
- **Step 3**
  - If there is sufficient interest (more than one firm committed to sharing in the costs of obtaining the opinion), ICMA will instruct counsel to proceed on the basis of written arrangements with participating firms

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GMRA bespoke opinion service

Conditions

- The participating firms, rather than ICMA, are **jointly and severally liable** for the cost of obtaining the opinion;
- The opinion will be **addressed solely to the participating firms**; and
- ICMA may, if it wishes, migrate the opinion to the body of industry standard opinions obtained by ICMA, at the relevant time at **no charge to ICMA.**

Migration from bespoke to industry standard opinion

- Once the bespoke opinion window is closed, ICMA may decide to migrate the bespoke opinions obtained into the body of industry standard opinions.
- ICMA will become liable for the cost of updating the opinion at this stage and from then on, on an annual basis.
- The decision as to whether an opinion is migrated will be based on the long standing criteria which ICMA has applied in assessing whether a new opinion/expansion of an existing opinion should be commissioned within the standard process.

Contact

Thank you, Ladies and Gentlemen

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Update on interoperability between the ICSDs for cleared "GC basket" repos

Jean-Robert Wilkin and Frank Reiss

Triparty Interoperability update

ERC AGM

Luxembourg, 18 January 2012

Triparty Interoperability - Background

- Model supporting GC basket trading, cleared by CCPs;

- Model presented by Clearstream and Euroclear to CCPs and trading platforms. Model supported by ERC and ECB

- Proposal consists in:
  - New « interoperable » basket(s) with trade input and collateral substitution up to ~14:00 CET (untill ICSDs' Bridge enhancement)
  - No change for existing « non-interoperable » baskets (LCH.Clearnet's - €GC and Eurex Clearing's - GC Pooling).

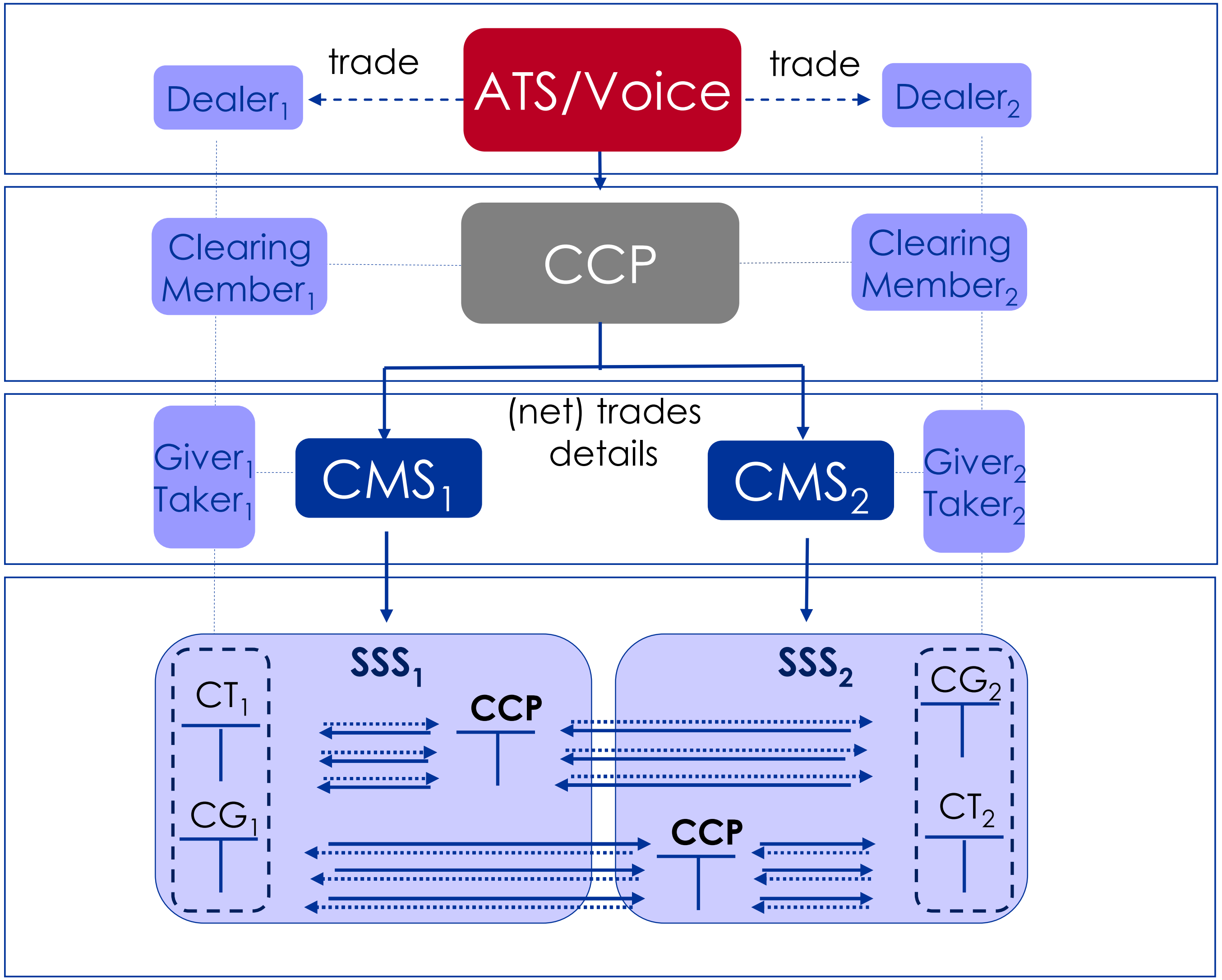
- No major obstacles for implementation but requires investments from:
  - Trading systems, CCPs, (I)CSDs.

- (I)CSDs requires 18 months for implementation after joint decision, Optimally to be delivered prior to CCBM2 and T2S launches.

- Model remains applicable after T2S implementation.

- Needs commitment from main CCPs to participate.

Triparty Interoperability – Model



Triparty Interoperability – Progress update

- Since September, discussion with 5 CCPs (LCH Clearnet Ltd , LCH Clearnet SA , Eurex Clearing AG , Cassa di Compensatione , Meff Clearing)

- Addtional CCPs requirements already identified
  - GC baskets eligibility to be defined per ISIN or per selection criteria
  - Collateral valuation to be provided by CCP or jointly by ICSDs (pricing from common external source)

- CCPs outstanding questions
  - Review detailed flows
  - Assess operational impact (settlement , tax-legal, treasury…)
  - Increase scope (CSDs , OTC) or keep current scope to 2 ICSDs
  - Walk through detailed life cycle and scenarii
  - Who is going to define the baskets ?

Triparty Interoperability – Next steps

- ICSDs proposal

1. January – March : a few joint workshops between CCPs and ICSDs to answer all CCPs questions / requirements.
2. End of March: ICSDs propose an updated description of the Triparty Interoperability model to all parties
3. April - May : All stakeholders assess their ability to implement such a model for their own product.
4. End of May : ICSDs and CCPs to communicate their respective decision to ERC on Go / No Go for the proposed model (June ERC meeting at ISLA conference)
5. If sufficient consensus, targeted first implementation by ICSDs at end of 2013.

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Development of an overnight repo fixing

Andreas Biewald

COMMERZBANK

Development of an Overnight Repo Fixing

General Meeting of ICMA's
European Repo Council on 18th of January 2012

Update on Benchmark Discussions with EBF

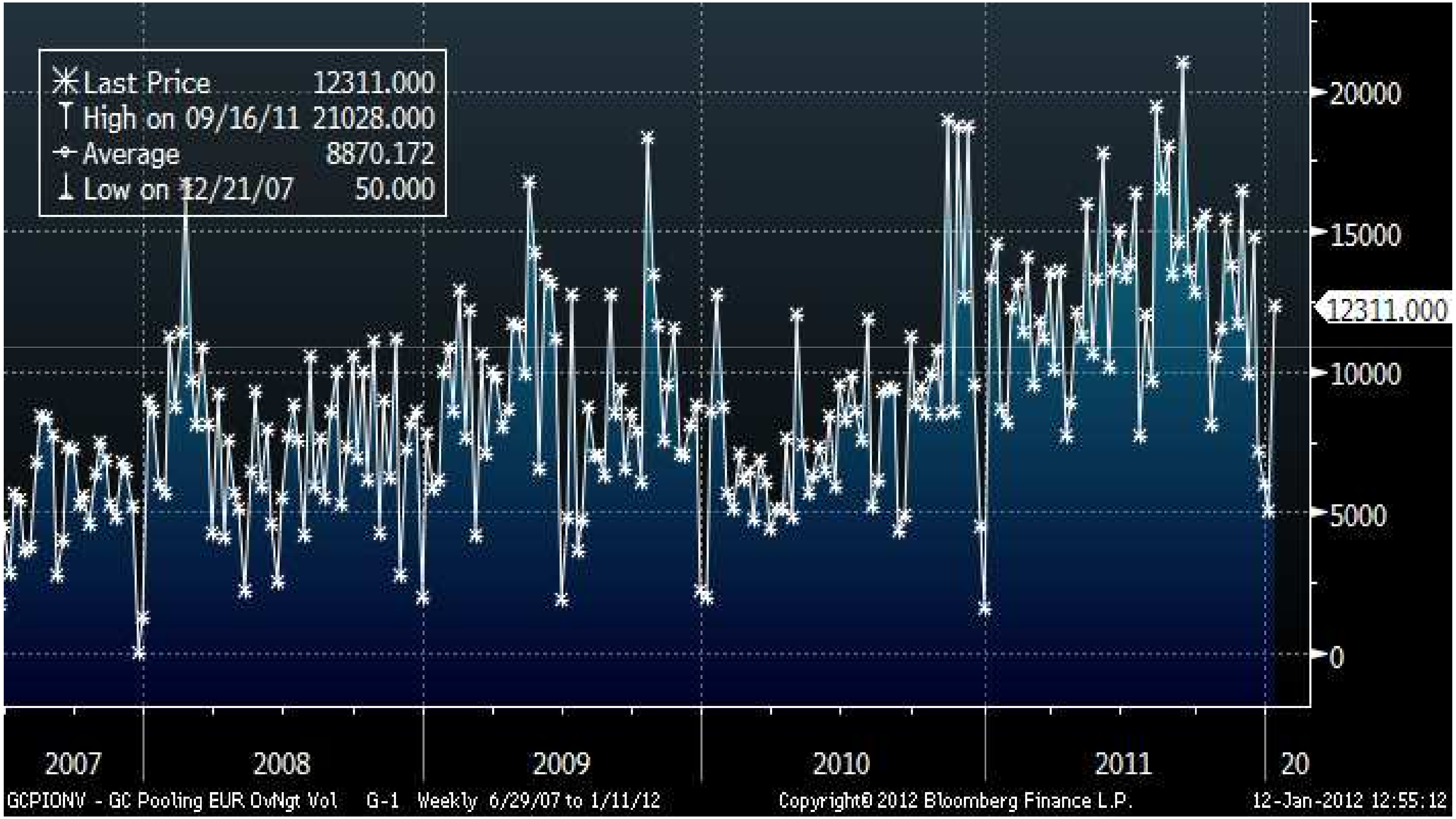
- The creation of an overnight repo index calculated on the basis of the effective trades reported by CCPs and calculated by the ECB (TBC officially by the ECB) has been approved both by the Eurepo Steering Committee and the Euribor - EBF General Assembly. The task force would like it to be issued in the course of 2012.

- Preliminary contacts with ECB already took place and the Eurepo task force hopes to get an official support in the coming months.

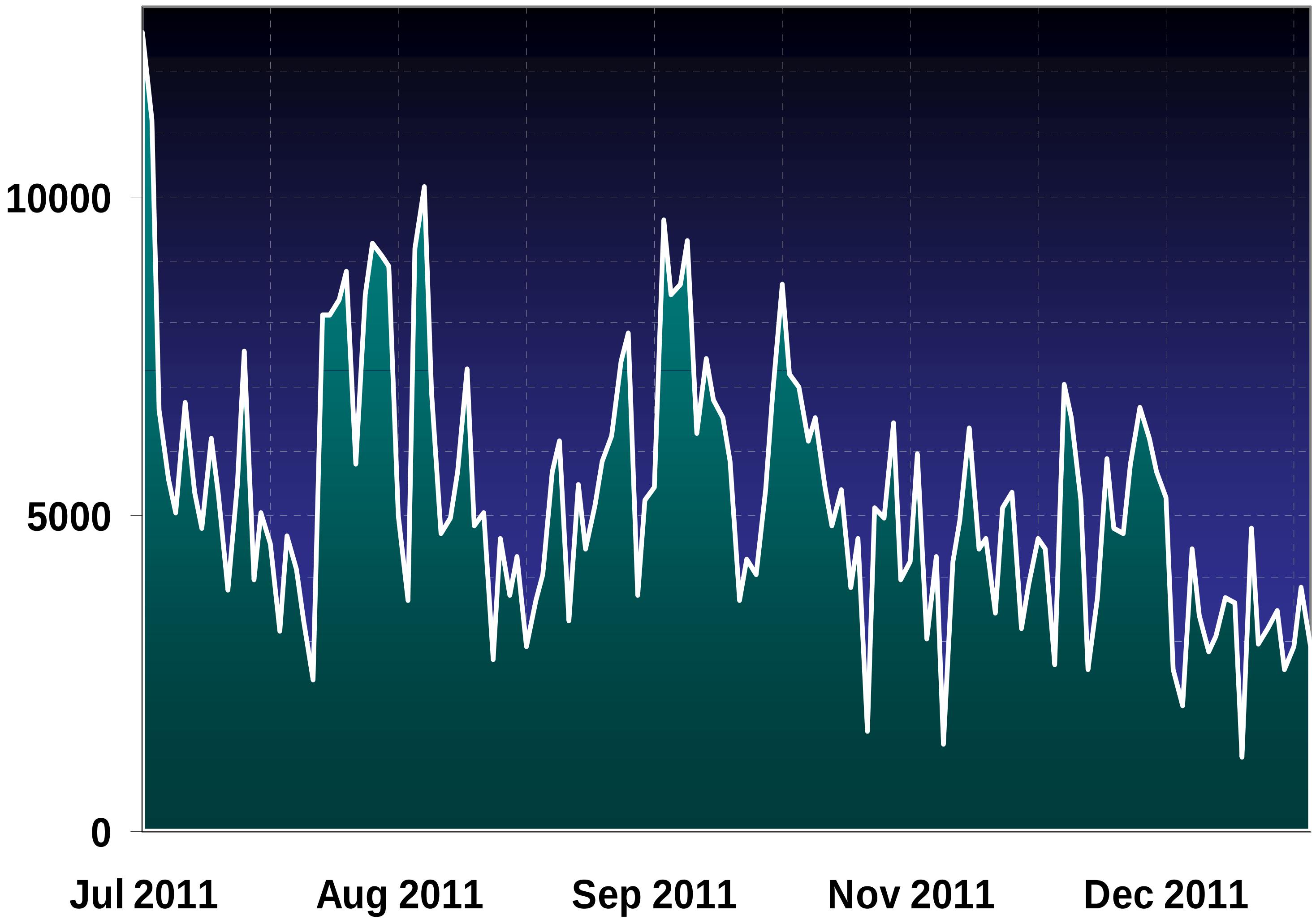
- The members highlighted the importance of having strong and detailed communications, in particular when explaining the difference between the new fixing and the existing Eurepo index.

EONIA Volume Over the Last 9 Years

GC Pooling Volume Over the Last 5 Years (O/N Transactions)



MTS Italy Volume Over the Last Year (O/N Transactions in Italian Governments)



Source: MMF Daily Bulletin

ERC Operations Group update

Nicholas Hamilton

ERC Operations. Agenda

- Repo trade matching best practice implementation.
- Repo margin. Operational guidelines revision. Implementation.
- Consultation and market development.

ERC Ops Agenda

Repo Trade matching- parameters agreed and published.

Compliance & Implementation work stream established.

Objective

- to publish to ERC members a view of their affirmation and matching commitments.

Rationale

- Pre-emptive action to demonstrate intent, completeness and efficiency in market
- Highlight opportunities for future efficiency through automation

Status

- ERC ops sub group activated
- Weekly sessions underway – MS, JPM, DB, UBS, SG, BTEC, BARCAP
- ERC operations membership broadcast prepared
- Problem statements under discussion

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ERC Ops Agenda

Repo margin. Revised Operational guidelines. Implementation *(Appendix 1)*

February 2012 publication with full ERC adoption by end June 2012

Revision Headlines (under discussion)

- Margin to be based on actual rather than assumed settlement. (portfolio value based on call date -1 eod). Requires an agreed and coordinated approach for adoption. Under discussion.
- GMRA 2011 now embraces 2 margin calculation methods. Increased scope for dispute. Participants should ensure mutual agreement and documentation of margin calculation to be used and whether it is applied at a transaction or portfolio level.
- Guidelines on minimum transfer amounts and interest.
- Avoid netting of consecutive days margin movements and bad practice of trading out of a margin call.
- Migration towards a call date +0 settlement of margin.

ERC Ops Agenda

Repo margin. Operational guidelines, revision

- Margin to be based on actual rather than assumed settlement. (portfolio value based on call date -1 eod actual). Ensure that margin is retained until the exposure has been removed through settlement.

Current prevailing convention.

- Include all pending on side legs.
- Exclude all pending off side legs

Proposal under discussion

- Exclude all pending on side legs
- Include all pending off side legs.

Consequences

- Collateral released prior to settled termination of the repo.
- Trades under margin prior to on side settlement.
- No exposure allowances made for fails.

- Margin retained until mtm exposure has been removed via confirmed expiration.
- Trades excluded until live.
- Allow for fails in the margin calculation.
- Some over-collateralisation on repurchases in a non T0 margin settlement arrangement.

Issue becomes less relevant on a same day margin call settlement basis, but allowance for fails would be best practice.

ERC Ops Agenda

Market Development and Consultation.

Objectives

- Ensure a good understanding of the intentions of each consultation document. Support ICMA in establishing appropriate regulation and legislation regarding the Secured Funding Markets.
- Providing input and partnering with the ICSD and CCP's in the development of plans for tri party settlement interoperability.

Challenges

- Volume of consultation documents for review.
- Ensuring collaboration and consistency where appropriate across market groups and participants responses.

Role of ERC Ops

- Ensure ERC/ICMA is furnished with, and including, an operations specialist view in its responses to the various consultation topics and documents. (e.g. Agent / CSG consultation, Securities Law directive, Settlement harmonisation)

Recent focus areas for consultation responses.

- CPSS-IOSSCO principles for FMI's.
- Securities Law Directive amendments.
- Settlement date harmonisation.
- Output from the FSB review of shadow banking.
- Interoperability.
- CSD/ICSD developments

Future group agenda

Market Operations

- Conclude Repo Margin guidelines revisions and target implementation date.
- Sponsor trade matching and act as an industry escalation point for non adherence.
- Represent the Repo Market Operations groups in escalation of market infrastructure instability and seek guidance on points of practice.
- Partner with MPC to review validity of current terminations and cash buy in rules.
- Review of settlement matching standards and CSD/ICSD enablement of unilateral cancellation

Market infrastructure development

- Continued engagement regarding interoperability and bridge development.
- Ongoing support of the repo white paper recommendations and observations.
- Ongoing regulatory consultation review and response.
- T2S and CCBM2 . Operational consultation.
- Operational input regarding credit claim collateral developments.

Appendix 1. Revision to margin practices.

1 Initial margin and haircut

Initial margins and haircuts may be used to adjust the value of collateral sold in a repurchase agreement in order to try to anticipate the loss of value that may be experienced if the collateral has to be liquidated following an event of a default by the counterparty.

An initial margin is defined as:

$$\frac{\text{Market Value of collateral}}{\text{Purchase Price}}\,100$$

This means that initial margin is expressed relative to 100% and that an initial margin of 100% means no margin. In the GMRA, initial margin is called Margin Ratio (see section 2(bb) of GMRA 2011).
[box: worked example]
A haircut is defined as:

$$\frac{\text{Market Value of collateral} - \text{Purchase Price}}{\text{Market Value of collateral}}\,100$$

This means that a haircut is expressed as the percentage difference between the Market Value of collateral and the Purchase Price of the repo. In the GMRA, haircut is called Margin Percentage (see section 2(aa) of GMRA 2011).
[box: worked example]. The application of initial margins and haircuts in the calculation of margin calls is described in (2) below. It is important to understand that, because an initial margin is a percentage of the Purchase Price, while a haircut is a percentage of the Market Value of collateral, the arithmetic of initial margins and haircuts is slightly different. For example, an initial margin of 102% is not equivalent to a haircut of 2%, but to 1.961% (ie 100/102%).
A party should be able to accommodate requests to apply initial margin to some repo transactions and haircuts to other transactions with the same counterparty. Initial margins and haircuts can be agreed in advance of trading and recorded in the legal agreement between parties (eg in Annex I of the GMRA), or can be agreed ad hoc at the point of trade and recorded in the confirmation. Once agreed for a particular transaction, the initial margin or haircut should be fixed for the term of that transaction. Note that it may be necessary in the case of asset-backed securities to apply a Pool Factor to reduce the dirty price of the security in the event it has suffered a Pool Factor Distortion, that is, where the principal has been written down to reflect insufficiency of underlying asset values or cashflows (see 10(f)(ii)(A) of GMRA 2011).

2 Calculating a margin call

A margin call should be made when one party has a Net Exposure to the other (see section 4(c) of GMRA 2011). A Net Exposure arises when the aggregate exposure of one party to another exceeds the aggregate exposure of the second party to the first. The aggregate exposure of each party is equal to the sum of the exposures on each transaction still outstanding with the other party (Transaction Exposure ---see section 2(xx) of GMRA 2011) plus any income due from the other party but unpaid (ie manufactured payments and interest payments) plus net margin still held by the first party. Transaction Exposure is calculated by marking each transaction to market. The mark-to-market calculation depends on whether the transaction is subject to an initial margin or to a haircut. In the interval between a margin call being made by one party and margin being delivered by the other, the calculation of Net Exposure should assume that margin will be delivered.

2.1 where the collateral is subject to an initial margin

$$\text{Transaction Exposure} = \left(\text{Repurchase Price}\,\frac{\text{initial margin}}{100}\right) - \text{Market Value of securities}$$

$$\text{Repurchase Price} = \text{Purchase Price}\left(1 + \frac{\text{repo rate x day count}}{100 \text{ x annual basis}}\right)$$

The Repurchase Price should be calculated for the day on which margin is due to be delivered (the margin delivery date). In other words, the day count for the repo rate should be the number of days up to but excluding the margin delivery date.

$$\text{Market Value of collateral} = \text{nominal value}\,\frac{\text{clean price} + \dfrac{\text{coupon x day count}}{\text{annual basis}}}{100}$$

The Market Value of collateral securities should include accrued interest up to but excluding the margin delivery date. [box: worked examples]

2.2 where the collateral is subject to a haircut

$$Transaction\ Exposure = Repurchase\ Price - \left[Market\ Value\ of\ securities\ \left(1 - \frac{haircut}{100}\right)\right]$$

Repurchase Price and Market Value of collateral are calculated as in (2.1).

[box: worked examples]

The day count and annual basis for the calculation of Repurchase Price follows the money market (ie deposit or forward FX) convention for the relevant currency (eg actual/360 for EUR, USD, CHF and JPY, and actual/365 for GBP).
The day count and annual basis for the calculation of the accrued interest in the Market Value of collateral follows the bond market convention for the relevant currency and security (eg actual/actual for all eurozone and most other government fixed-income securities).

3 What transactions are included in the calculation of Net Exposure?

3.1 general rule

The calculation of Net Exposure should include all transactions between two parties for which:

- the Purchase Date is today or earlier
- the Repurchase Date is today or later.

The inclusion of new or maturing transactions should be based on actual rather than assumed settlement. However, this practice requires firms to have the ability to confirm settlement before making or responding to a margin call.

Where firms cannot confirm settlement before making or responding to a margin call, then the above general rule should be applied literally. In other words, transactions should be included in the calculation of Net Exposure on both their Purchase Date and Repurchase Date. This means assuming settlement on the Purchase Date but not on the Repurchase Date. The reason for this asymmetry of treatment is that settlement failures on the Repurchase Date are more common and are likely to have larger Transaction Exposures than new transactions. Transactions which fail on their Purchase Date should be removed from the calculation of Net Exposure on next business day and not included until the failure has been remedied by the Seller or the transaction has been terminated by the Buyer. Transactions which fail on their Repurchase Date should continue to be included in the calculation of Net Exposure until the failure has been remedied by the Buyer or the transaction has been terminated by the Seller, as the transaction will continue to have a Transaction Exposure.

Where margin is paid or delivered for value on T+1 and T+2, the inclusion of repos up until their Repurchase Date means that margin may be paid or delivered after the Repurchase Date. The alternative is not to margin for collateral price movements over the last one or two business days of a transaction, which is a greater risk than overextended collateralisation. Any excess margin delivered as a result of this practice will be eliminated by the next margin call. Paying or delivering margin for value on T+0 may not entirely eliminate this problem, as margin may still be paid or delivered on the day that the underlying Transaction Exposure disappears and is unlikely to then be returned until the next business day. However, T+0 margin will significantly reduce the problem.

[box: worked examples]

The reason for not including transactions between their Transaction Date and Purchase Date is that, if the Seller does fail to deliver collateral on the Purchase Date, provided the Buyer has not paid the Purchase Price to the Seller, the Buyer will only have an interest rate risk, sometimes called a “net replacement cost”, rather than the type of credit risk to which a counterparty is exposed once an exchange of cash and collateral has actually taken place (the risk of losing principal). Such a risk should be hedged with interest rate risk management instruments rather than collateral.

3.2 forward repos

On the above basis, forward repos should not be included in the calculation of Net Exposure (until they reach their Purchase Dates and cease to be forward transactions). This is because, until collateral and cash are exchanged on the forward Purchase Date, the only risk on the transaction that is posed by the possible default of one of the parties is that the non-defaulting party will have to arrange a replacement transaction at a worse repo rate or buy-back price. In other words, until the Purchase Date, the risk on a forward repo is an interest rate risk (similar to the counterparty risk on a derivative) rather than the type of credit risk to which a counterparty is exposed from the Purchase Date (the risk of losing principal). The risk on a forward repo prior to its Purchase Date can be mitigated by various measures set out in the GMRA (see 2(c) of Annex I of GMRA 2011).

Appendix 1. Revision to margin practices.

4 What prices are used to value collateral?

Collateral securities must be valued at their dirty or gross prices (ie including accrued interest), rather than their clean prices. The number of days used in the calculation of accrued interest should be calculated from and including the last coupon payment date up to but excluding the date on which margin is due to be delivered (the margin delivery date). This means that the Market Value of collateral securities should include accrued interest up to but excluding the margin delivery date. Because the dirty or gross price of a collateral fixed-income security is used to calculate its Market Value, the payment of a coupon will reduce the Market Value of that security and may trigger a margin call. The same principle applies to equity collateral and payments of dividends. It is best practice to monitor forthcoming coupon or dividend payments.

To value each piece of collateral, the most common practice is to use the middle (clean) price quoted or dealt in the Appropriate Market for that security (see 2(d) of GMRA 2011) at the close of business on the business day before the date of calculation and call. The middle price assumes that the Buyer and Seller are equally likely to default. Alternatively, the parties could agree to use the bid price, which would provide the maximum protection for the Buyer. The Market Value of collateral fixed-income securities should include accrued interest up to but excluding the margin delivery date.

In the event of exceptional intra-day collateral price movements, parties can agree to intra-day margin calls, which should use the latest available price.

Disagreement on the prices used in valuing collateral can be avoided if the sources are listed in the legal agreement between two parties. However, this is not always practicable. Instead, the most common practice is for repo dealers to use prices taken from the internal price database of the margin caller. If there is a disagreement about the price used to value collateral and no price source is specified in the legal agreement, the parties should agree a source, negotiating reasonably and in good faith.

In calculating the Repurchase Price or Buy-Back Price of a sell/buy-back, where the collateral is a fixed-income security, it is necessary to include the reinvestment income on any coupons paid during the term of the transaction. If the coupon is due to be paid during the term of the transaction and the coupon payment date falls on a non-business day, the Repurchase Price or Buy-Back Price should assume that the reinvestment of the coupon until the Repurchase Price or Buy-Back Price starts on the next business day.

5 How often should Net Exposure be calculated and margin called?

Net Exposure should be calculated at least every business day. In exceptional circumstances, it can be calculated intra-day.

Margin should be called whenever Net Exposure exceeds an acceptable threshold (see (9) below).

6 Margin thresholds and Minimum Transfer Amounts

Parties to repurchase agreements (but not sell/buy-backs) often agree a minimum Net Exposure below which they will not call a margin from each other. Once the Net Exposure equals or exceeds this threshold, a margin is called which is sufficient to eliminate the entire Net Exposure. For this reason, the threshold is often called a Minimum Transfer Amount. A Net Exposure below the Minimum Transfer Amount is an unsecured credit exposure and should be subject to the credit limit for repo. Minimum Transfer Amounts should be agreed before trading starts. In practice, parties usually record mutually-agreed Minimum Transfer Amounts in their legal agreements.

A party may prefer not to agree a Minimum Transfer Amount with a counterparty and thereby commit itself to potentially extending unsecured credit. Instead, it may decide on a confidential Minimum Transfer Amount that it will observe internally, but will not make that amount known to the counterparty. This will allow it to reduce or eliminate the Minimum Transfer Amount in the event of concerns arising over the creditworthiness of the counterparty.

7 What is the deadline for making a margin call?

Margin calls should be made before 14:00 CET. All transactions listed in section 3 should be included. Margin calls made after 14:00 CET should be treated as though they had been made on the next business day.
If a party receiving a margin call wishes to provide securities in response to the margin call, it must select the issues and notify the other party of the selection before 16:00 CET. If the second party has a problem with the issues selected by the margin-giver, it should promptly inform the first party (see (8) below).

8 Where margin is given in the form of securities, what issues have to be accepted by the margin-taker?

Securities given as margin on repurchase agreements (but not sell/buy-backs) should be accepted if they are recognised as general collateral in the repo market or if they have characteristics the same as or better than the collateral being reversed in by the margin-taker. It is best practice to specify acceptable margin securities in the legal agreement between the parties. If this is not possible, the margin-taker should act reasonably and in good faith when offered margin securities.

9 Should initial margin or haircut be deducted from margin securities?

If an initial margin or haircut has been taken from a particular issue of securities used as collateral in a repo with a particular counterparty, it is logical to apply an initial margin or haircut to that same security if it is to be given as margin. However, the initial margin or haircut to be imposed on margin securities could be different from that imposed on the same securities when they were first repoed because of changing circumstances in the interval between the Purchase Date and the margin call.

10 What is the deadline for delivering margin?

Margin should be delivered within the deadline agreed between the parties. It is best practice to deliver cash margin on the same day as the call is made (T+0). It is also best practice to deliver margin securities on the same day as the call is made (T+0) but the most common practice currently is to deliver margin securities one or two days after the margin calls (T+1 and T+2).

11 Can margin securities be substituted?

Securities given as margin by one party to a repo can be substituted with the agreement of the other party, who should act reasonably and in good faith in response to such a request.

Parties often require substitute securities to be delivered before the original securities are released. Substitute securities and securities being substituted should be delivered in line with (10) above.

12 Interest payments on cash margin

Interest is due on cash margin, except where this is paid as a Cash Equivalent Amount because of a failure by the Buyer to return certain collateral securities on the Repurchase Date (see 4(h)(i) of GMRA 2011). Interest should be accrued on cash margin at a rate indexed to a reference rate agreed between the parties plus or minus an agreed spread. Common reference rates are overnight indexes such as EONIA for EUR, SONIA or RONIA for GBP and Fed Funds Effective for USD. Interest accruing on cash margin up to but excluding the day on which margin called today is due to be delivered (the margin delivery date) should be included in the calculation of Net Exposure.
In the event of negative interest rates, the interest rate on cash margin should be set to zero.

13 How is “repricing” used to eliminate Net Exposures?

Net Exposures on sell/buy-backs and many repurchase agreements are not eliminated by means of margin. Instead, the transaction is terminated and simultaneously a new transaction is created for the remaining term in which either (1) the Purchase Price of the new transaction is set equal to the new Market Value of the securities or (2) the nominal value of the securities is changed to bring the Market Value at the new market price into line with the original Purchase Price (see 4(j) of GMRA 2011). In method (1), the Repurchase Price of the terminated transaction (as of the termination date) and the Purchase Price of the new transaction should be set-off and paid net. In method (2), the amount of the collateral securities of the terminated transaction and the amount of the collateral securities of the new transaction should, if they are the same (see below), be set off and delivered net.

These methods are sometimes collectively called “repricing”. In the GMRA, however, the first method is called Repricing and the second method is called Adjustment. Under the Repricing method, accrued repo interest is “cleaned up”, ie paid over to the Buyer by not including in the new Purchase Price. Whereas margining is applied to transactions in aggregate, Repricing and Adjustment have to be applied to individual transactions. It is usual to reprice or adjust transactions in sequence, starting with the transaction with the highest Transaction Exposure, and continuing until Net Exposure is reduced to an acceptable level. Under the GMRA, when a transaction is adjusted, the parties can agree to allow the substitution of the collateral. The Repricing method is more common than the Adjustment method.

14 When is margin returned?

Cash margin and margin securities held by one party are not automatically returned to the other party unless the second party specifically requests the return of previous margin when making a margin call on the first party.

15 What happens if margin is not delivered?

Failure to deliver margin is an event of default. It is not however an automatic event of default, so the non-defaulting party is required to serve a Default Notice in order to trigger a default. If the non-defaulting party chooses not to serve a Default Notice, the defaulting party should endeavour to deliver margin at the earliest opportunity. Delayed payments or deliveries of margin from one party should not be set off against margin calls made on the other party on subsequent days. To do so would encourage the unacceptable practice of trying to avoid a margin call by rolling that obligation forward to see if movements in market prices eliminate Transaction Exposures.

However, if a party making a margin call requests the return of margin securities delivered to the other party in response to a previous margin call, but the other party is unable to return those securities, despite its best endeavours because of circumstances beyond its control, the GMRA 2011 allows the undelivered margin securities to be substituted by means of payment of a Cash Equivalent Amount (see 4(h) of GMRA 2011).

16 Margin parameters to be agreed between parties before trading.

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Regulatory issues

Lalitha Colaco-Henry and David Hiscock

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International Capital Market Association

Update on Regulatory Issues
Short selling and MiFID

Lalitha Colaco-Henry, ICMA

**European Repo Council
General Meeting**

**Luxembourg
18 January 2012**

Short Selling

The European Parliament and Council agreed the text of the **Short Selling Regulation** in mid-October. The Regulation was approved by the Parliament on November 15th and the Council's approval is expected in February.

Definition of a short sale:

When a person (A) enters into a contract to sell a security which:

- A does not own; or
- A has borrowed or agreed to borrow for delivery at settlement.

Repo and Securities Lending are excluded from this definition.

Restriction on short sales of **sovereign debt** – Article 12

A short sale may only be entered into if the person has:

a) borrowed the securities or made alternative provisions resulting in a similar legal effect;

b) entered into an agreement to borrow the securities or have a legally binding claim to be transferred ownership of the securities so that settlement can be effected when due;

c) entered into an agreement with a third party under which that third party has confirmed that the securities have been **located** or there is a **reasonable expectation** that settlement can be effected when it is due.

There are important differences between the sovereign debt and equity restrictions.

ESMA, in the first Level 2 consultation, is likely to consider:

- What evidence can short sellers rely upon to establish that a third party has **located** the debt securities?
- What evidence can a third party rely upon to establish that there is a **reasonable expectation** that settlement can be effected when due?
- How is “third party” to be defined?
- How is “arrangement” to be defined?
- How is a “confirmation” (to be given by the third party to the short seller) to be defined?

Excluded from the definition of short sale are:

a) a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price;

b) a transfer of securities under a securities lending agreement;

c) entering into a futures contract or other derivatives contract where it is agreed to sell securities at a specified price at a future date.

Transferable Securities means those classes of securities which are negotiable on the capital market, with the exception of instruments of payments, such as:

a) shares in companies and other securities equivalent to shares in companies or other entities, and depositary receipts in respect of shares;

b) bonds or other forms of securities debt, including depositary receipts in respect of such securities;

c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

An **Organised Trading Facility** is:

"any system or facility, which is not a regulated market (RM) or Multilateral Trading Facility (MTF), operated by an investment firm or a market operator, in which multiple third-party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract"

Transaction reporting will apply to “financial instruments” but **excluded** are:

- Financial instruments which are not admitted to trading or traded on a MTF or OTF;
- Financial instruments whose value does not depend on the value of a financial instrument admitted to trading or traded on a MTF or OTF;
- Financial instruments which do not, or are not likely to, have an effect on a financial instrument admitted to trading or traded on an MTF or OTF.

Contacts

Thank you, Ladies and Gentlemen

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Update on Regulatory Issues

David Hiscock, ICMA

European Repo Council
General Meeting

Luxembourg
18 January 2012

Oversight and regulation of shadow banking

- The FSB aims to strengthen oversight and regulation of shadow banking
  - One of its five workstreams is regulation of activities related to securities lending/repos, including possible measures on margins and haircuts
    - This is being managed an FSB working group encompassing broad international involvement; and led by David Rule from the UK FSA – ERC is actively engaged
    - FSB has identified three main areas that may need to be considered
      - Regulating securities lending-related cash collateral reinvestment programmes;
      - Macro-prudential measures related to repos and securities lending; and
      - Improving market infrastructure for secured funding markets
    - The Bank of England hosted a 1 December meeting of this FSB working group
      - First agenda item was “Repo Market with specific focus on Europe”: market input was provided by the ERC Chair and three other ERC Committee members
      - ISLA were also involved in this meeting with respect to securities lending

Commission – Basel Adoption

Proposed new regulatory capital standards

- Basel III rules text, covering capital and liquidity, issued on 16.12.10
  - On 20.07.11 the European Commission issued its related proposals
- Includes the introduction of 2 new liquidity standards
  - Short-term, Liquidity Coverage Ratio (LCR) - to be introduced by 2015; and
  - Longer term, Net Stable Funding Ratio (NSFR) - to be introduced by 2018
  - For LCR a key aspect is the definition of “liquid assets”
    - Some expansion of the allowable assets for inclusion continues to be debated
    - EU will only finalise its proposals once Basel has agreed the international standard
      - In principle this will mean a single set of rules applied across the whole EU
      - Until then Member State level differences persist in the setting of liquidity rules

European Commission – New regulation re CSDs

- Whilst delayed into 2012, the Commission CSD Regulation will be proposed
  - Will establish a new regime for authorised providers of CSD services
  - Will also include potentially significant provisions relating to market efficiency:
    - Standardisation of settlement at T+2;
    - Market discipline (buy-ins);
    - CSD interoperability and access; and
    - Cash settlement (in central or commercial bank money)

- Also anticipate securities law directive and new regulation re close out netting

European Commission – Future of post-trade

- Commission considers more may be needed beyond existing proposals
  - Through 2011 two expert working groups aided its thought process
    - Expert Group on Market Infrastructures (EGMI);
    - Tax barriers Business Advisory Group -T-BAG
  - 24.10.11 conference on European post trading landscape: “The Road Ahead”
    - Discussions focused on how to improve the safety of the European post-trading landscape – particularly considering risks posed by CCPs
    - Also some discussion of market efficiency centred around the development of T2S
    - Elimination of the Giovannini barriers, including the way they will be affected by the forthcoming regulatory changes and T2S, was also considered

IASB and FASB – Update of netting rules

- Conclusions have been reached following exposure draft consultation
  - The two Boards have retained their existing (different) offsetting models
  - Revised common offsetting disclosure requirements issued 16.12.11
    - Aim to help investors/other financial statement users to better assess the effect /potential effect of offsetting arrangements on a company's financial position
      - Also improve transparency in the reporting of how companies mitigate credit risk, including disclosure of related collateral pledged or received
      - Disclosures are effective for annual periods beginning on or after 01.01.13
  - IASB also decided to separately provide additional application guidance for offsetting in accordance with IAS 32
    - Aims to address current practice issues identified during outreach - it clarifies:
      - The meaning of "currently has a legally enforceable right of set-off"; and
      - That some gross settlement systems may be seen as equivalent to net settlement

European Union – FTT

- On 28.09.11 the Commission announced its proposals for a Financial Transaction Tax (FTT) in the 27 Member States of the EU
  - The tax would be levied on all financial institutions' transactions in financial instruments, when at least one party to the transaction is located in the EU
  - With effect from 01.01.14 the exchange of shares and bonds would (at minimum) be taxed at a rate of 0.1%; and derivative contracts, at 0.01%
- Significant political controversy means the way ahead remains uncertain
  - UK veto? Eurozone only instead of EU wide? France takes individual lead?
- If implemented as proposed, the effect on repo would be devastating

Collateral – An area of special focus

- Importance of collateral significantly accelerated since the financial crisis
  - Demands have significantly increased: market and regulatory pressures
    - Covered bond and repo financing; liquidity buffers; CCP/bi-lateral OTC margins
  - Widely perceived that collateral demands will significantly outstrip supply
    - Essential that collateral be managed as a scarce resource i.e. optimise use
      - Broaden universe of available collateral assets e.g. credit claims for repo
      - Increase efficiency of collateral utilisation e.g. triparty settlement interoperability
      - Promote harmonisation e.g. Basel liquidity rules / ECB (CCBM2/T2S/COGESI)
  - ICMA seeks to leverage private sector efforts by promoting a new CICF
    - CICF to be Chaired by Mr Godfried De Vidts
    - Bring to together trade association efforts across the industry
    - Channel efforts into applicable official sector projects

Contacts

Thank you, Ladies and Gentlemen

Contacts and information:

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ICMA

International Capital Market Association

Repo survey

Richard Comotto

ICMA
International Capital Market Association

European Repo Council

22nd European repo market survey
conducted in December 2011

Survey overview

- Outstanding value of contracts at close of business on Wednesday, 7th December 2011
- 64 responses from 59 groups

Headline numbers

- December 2011 EUR 6,204 billion
- June 2011 EUR 6,124 billion
- December 2010 EUR 5,908 billion
- June 2010 EUR 6,979 billion
- December 2009 EUR 5,582 billion
- June 2009 EUR 4,868 billion
- December 2008 EUR 4,633 billion
- June 2008 EUR 6,504 billion
- December 2007 EUR 6,382 billion
- June 2007 EUR 6,775 billion
- December 2006 EUR 6,430 billion
- June 2006 EUR 6,019 billion
- December 2005 EUR 5,883 billion

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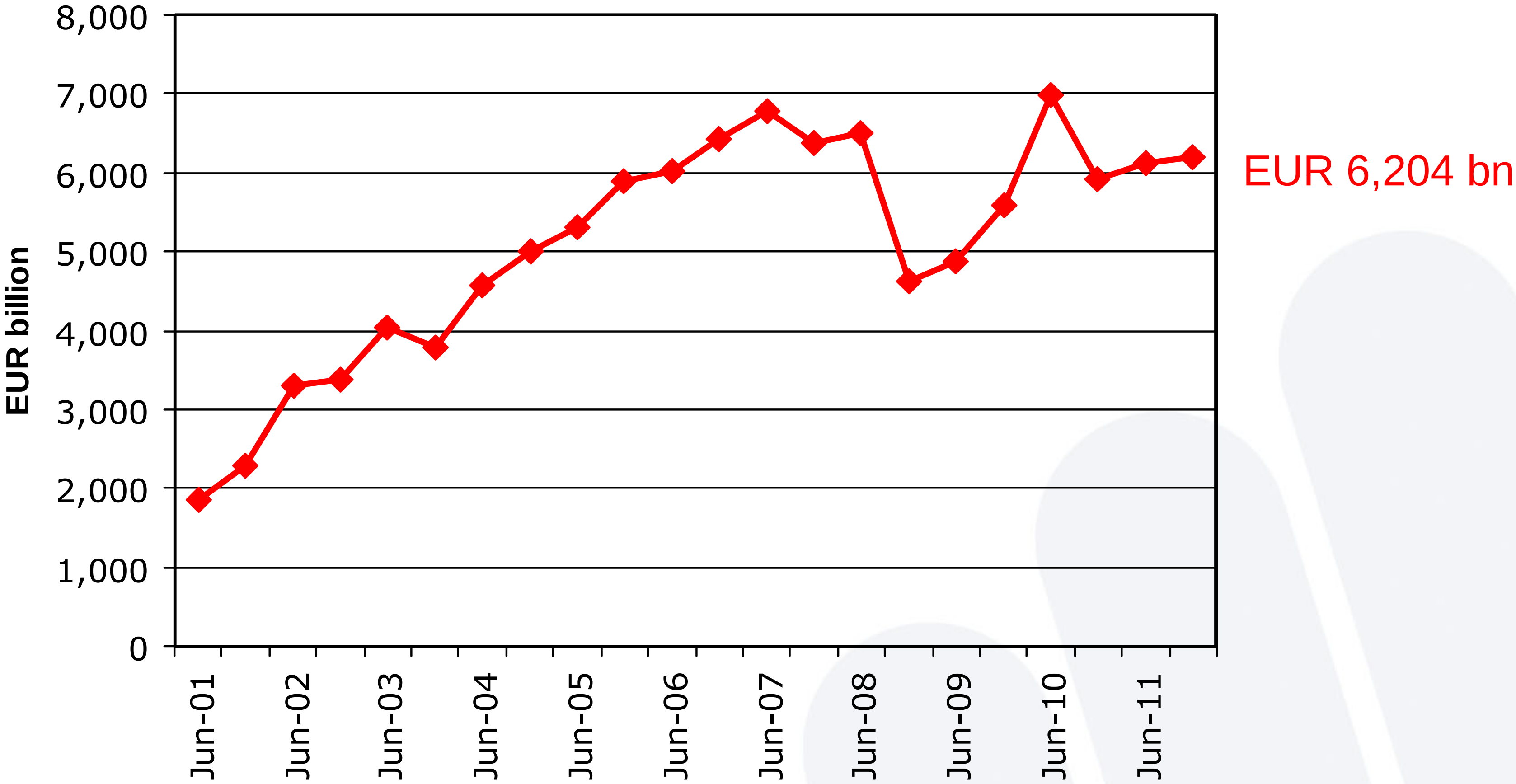
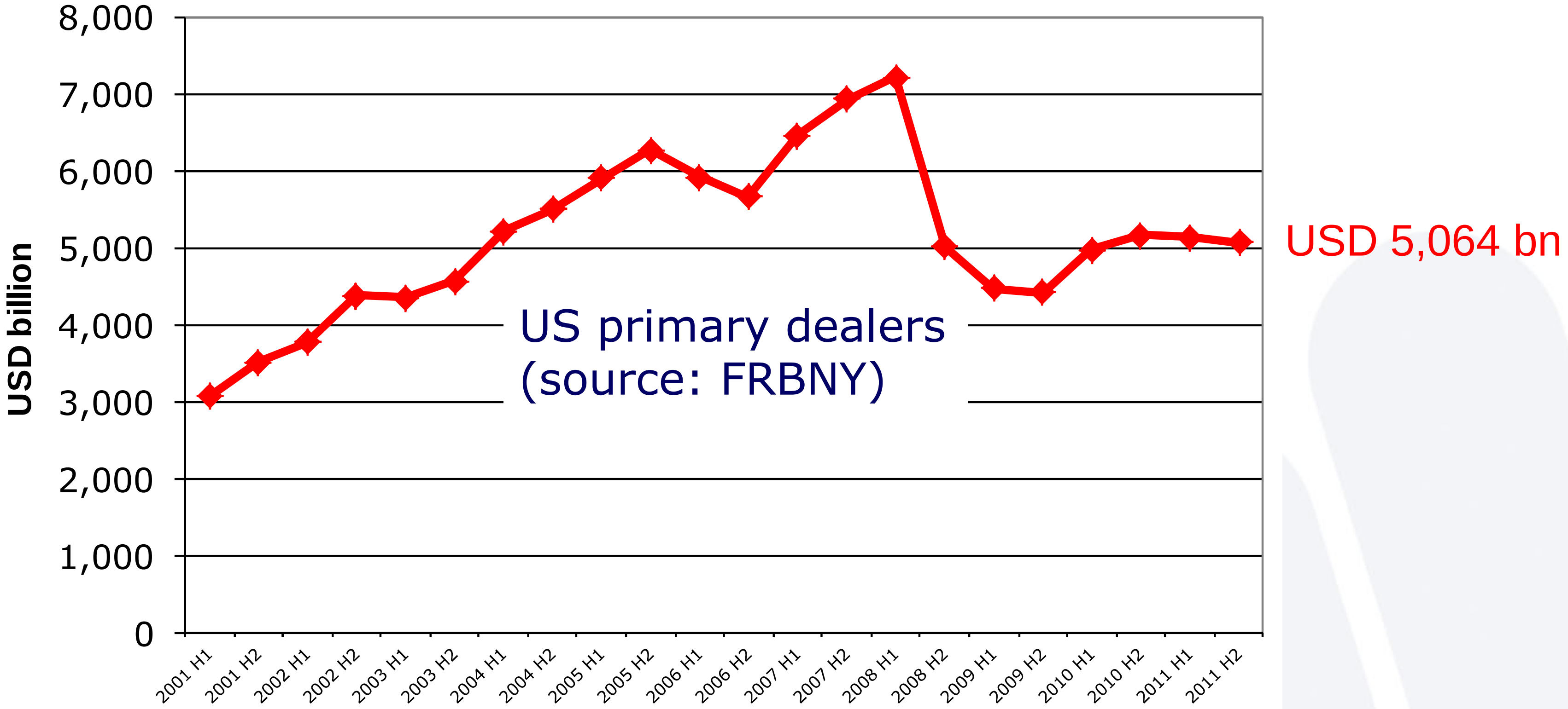
22nd European repo market survey conducted in December 2011

Headline numbers



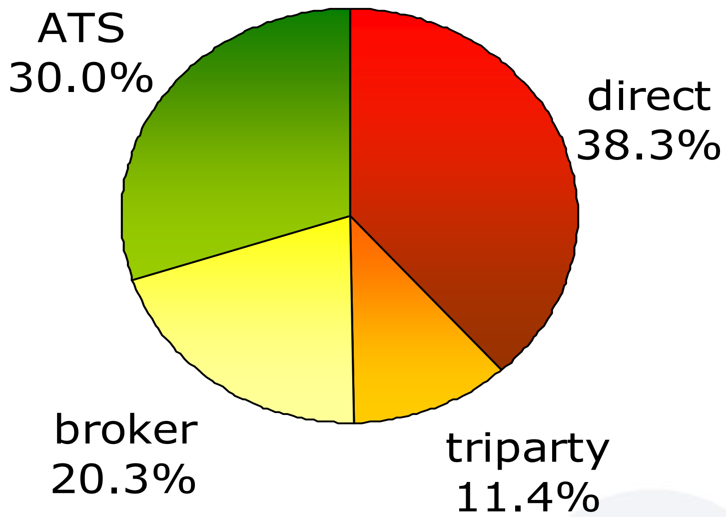
US market


8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
USD billion
US primary dealers (source: FRBNY)
USD 5,064 bn
2001 H1
2001 H2
2002 H1
2002 H2
2003 H1
2003 H2
2004 H1
2004 H2
2005 H1
2005 H2
2006 H1
2006 H2
2007 H1
2007 H2
2008 H1
2008 H2
2009 H1
2009 H2
2010 H1
2010 H2
2011 H1
2011 H2

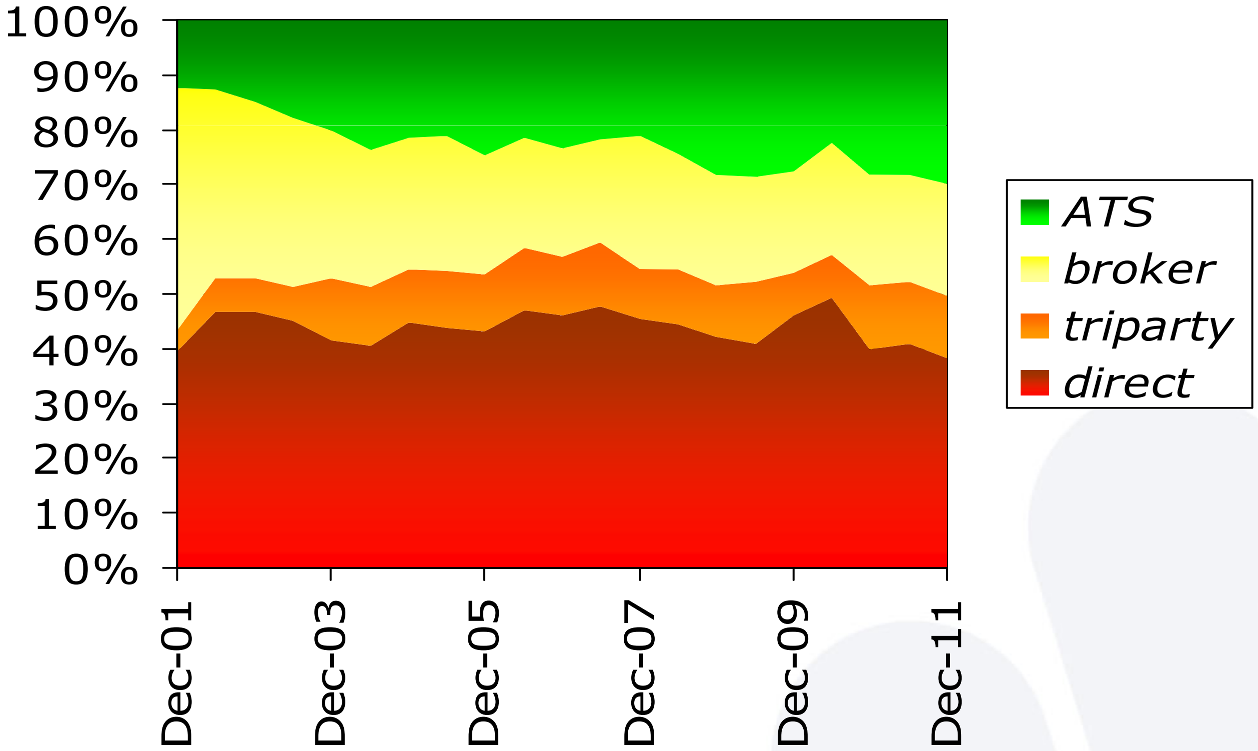
Comparable market growth

- 51 respondents in last 3 surveys
  - -3.3% since June 2011
- 54 respondents in December 2011 and 2010 surveys
  - +2.6% year-on-year

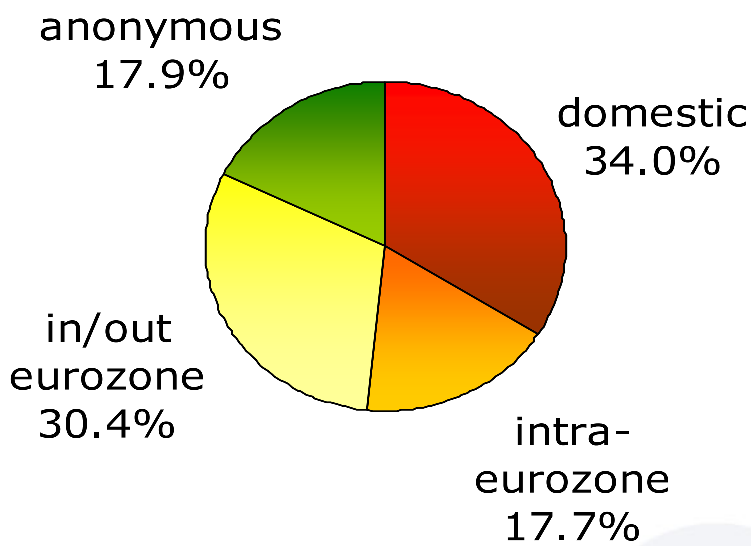
Counterparty analysis



Counterparty analysis



Geographical analysis



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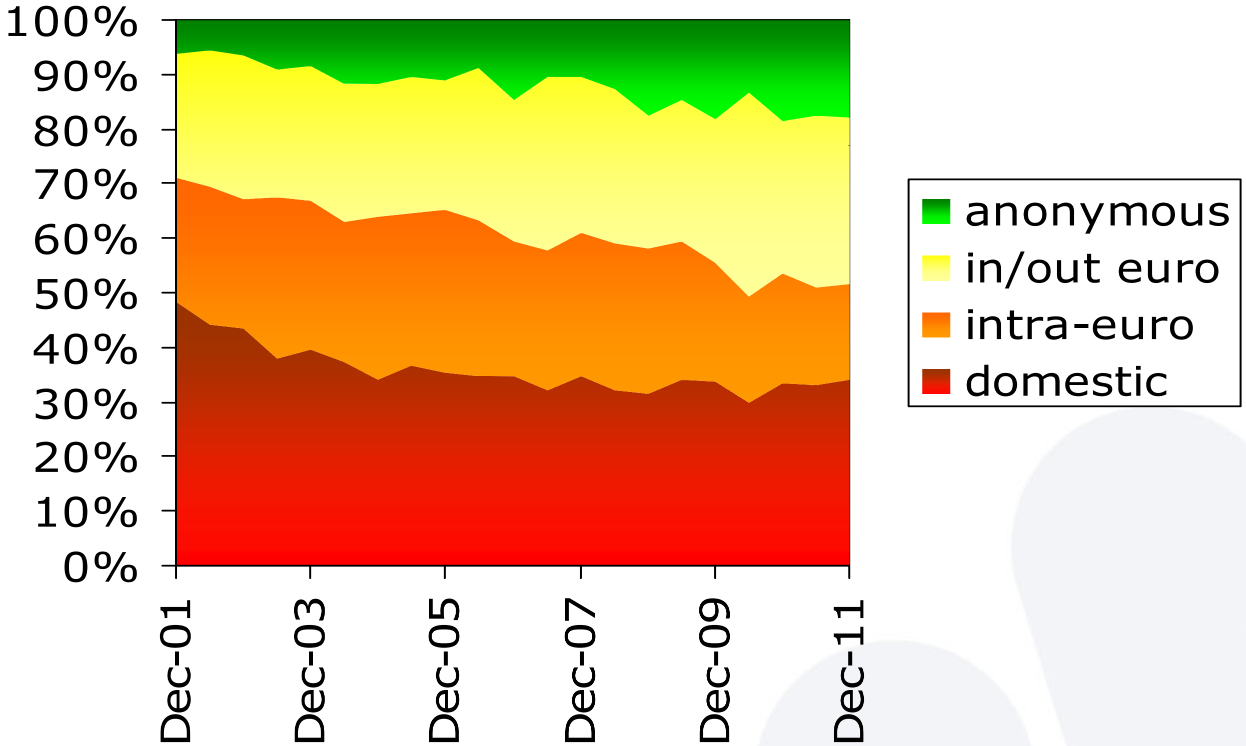
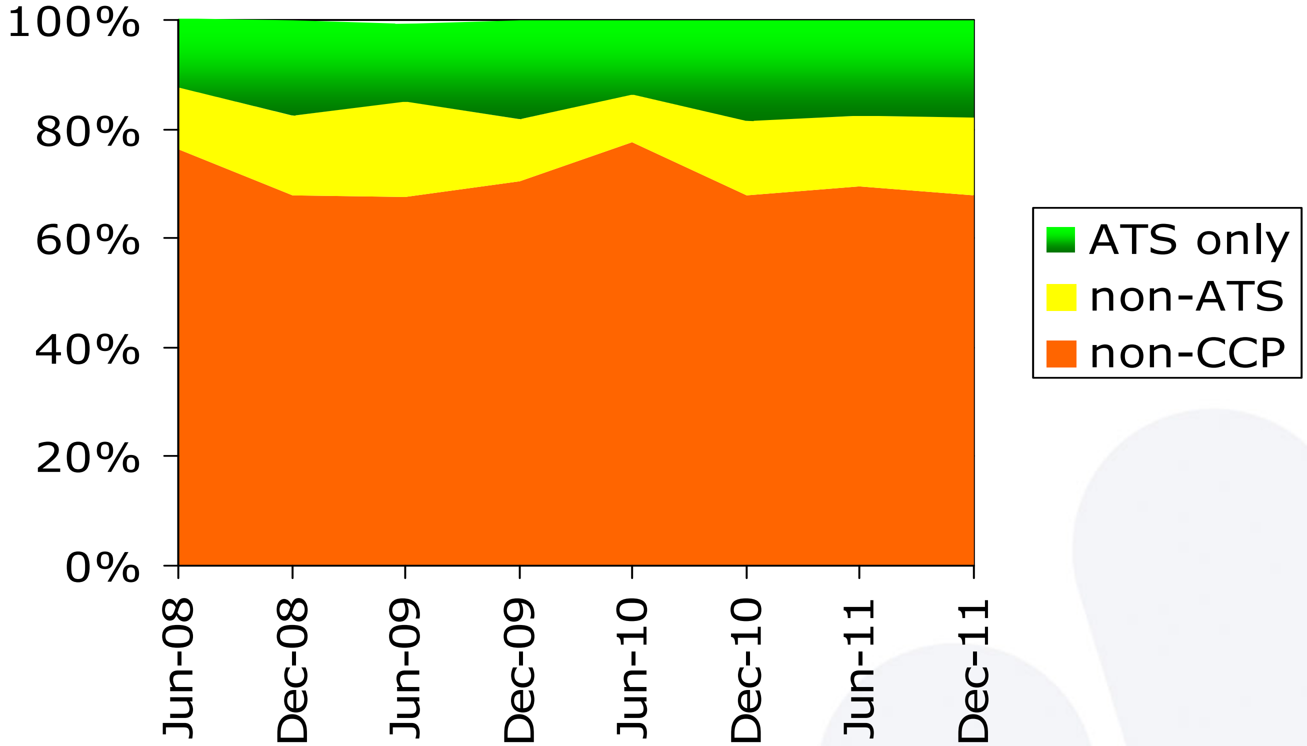
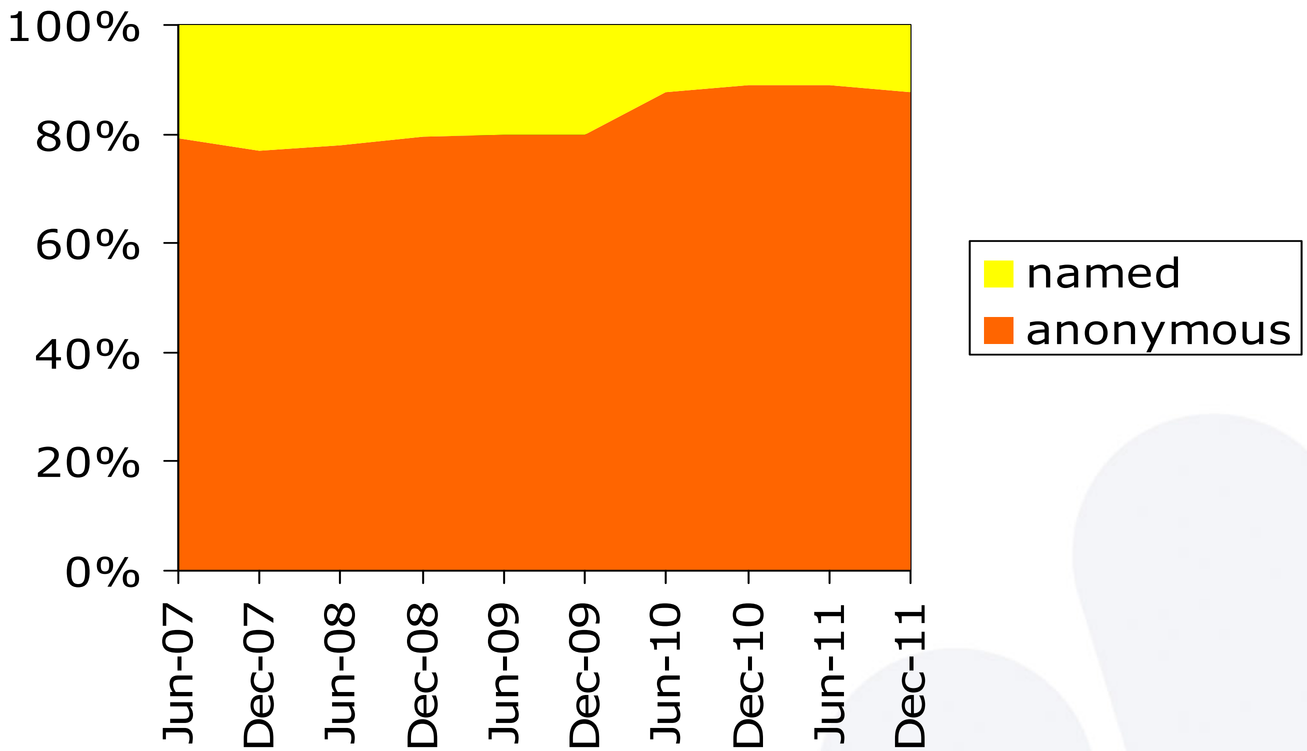
Geographical analysis



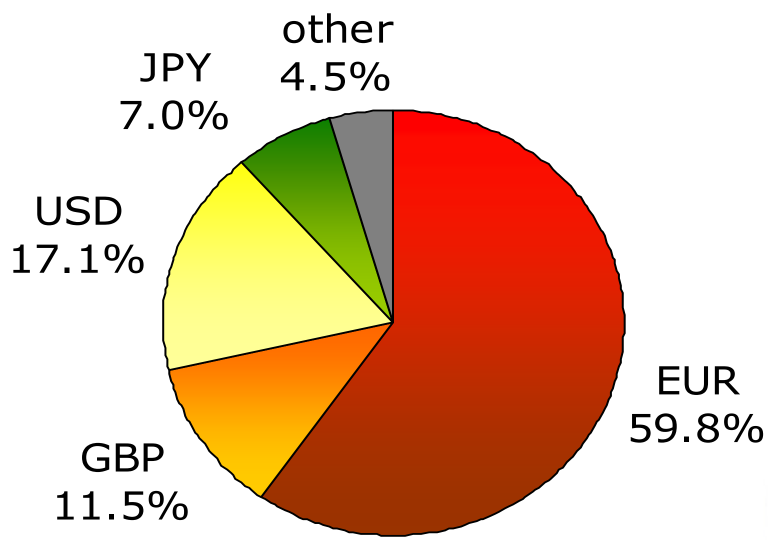
Business cleared across CCP



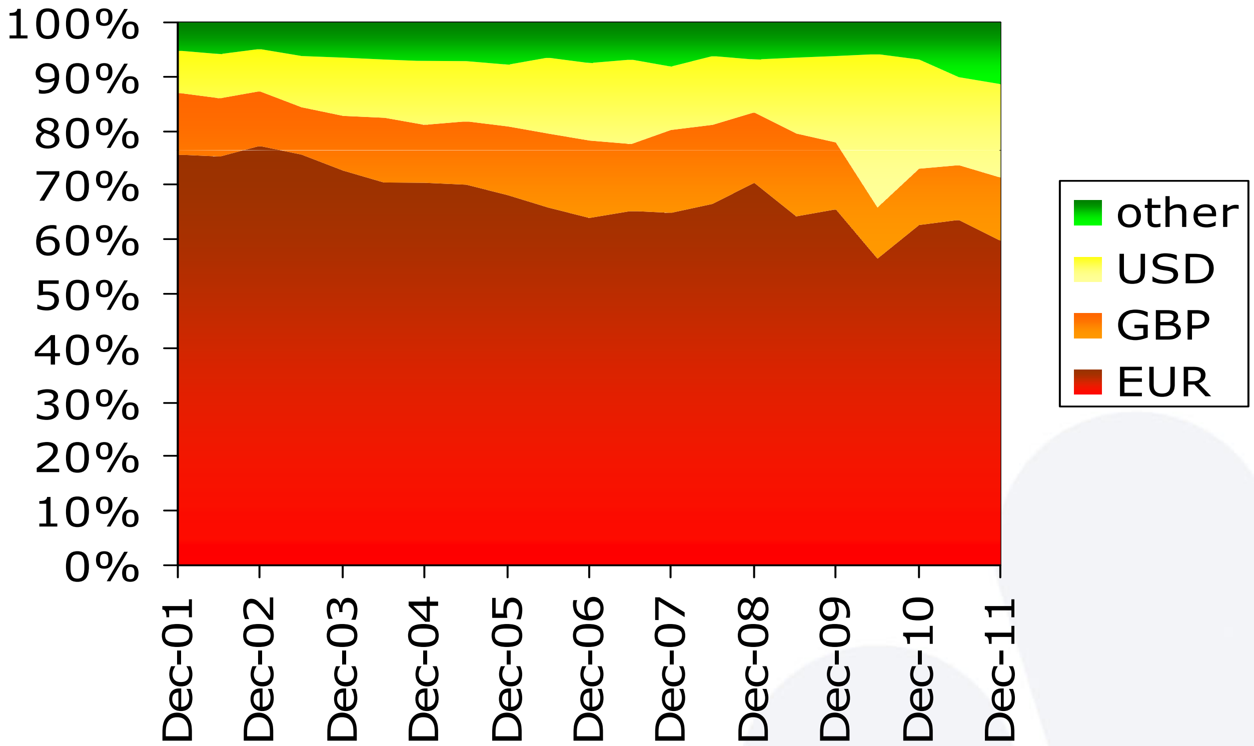
Anonymous ATS business



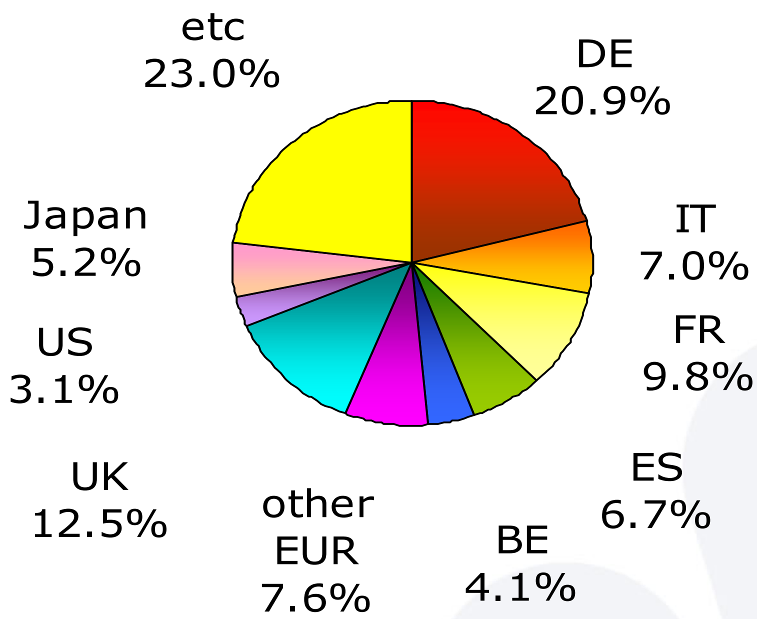
Currency analysis



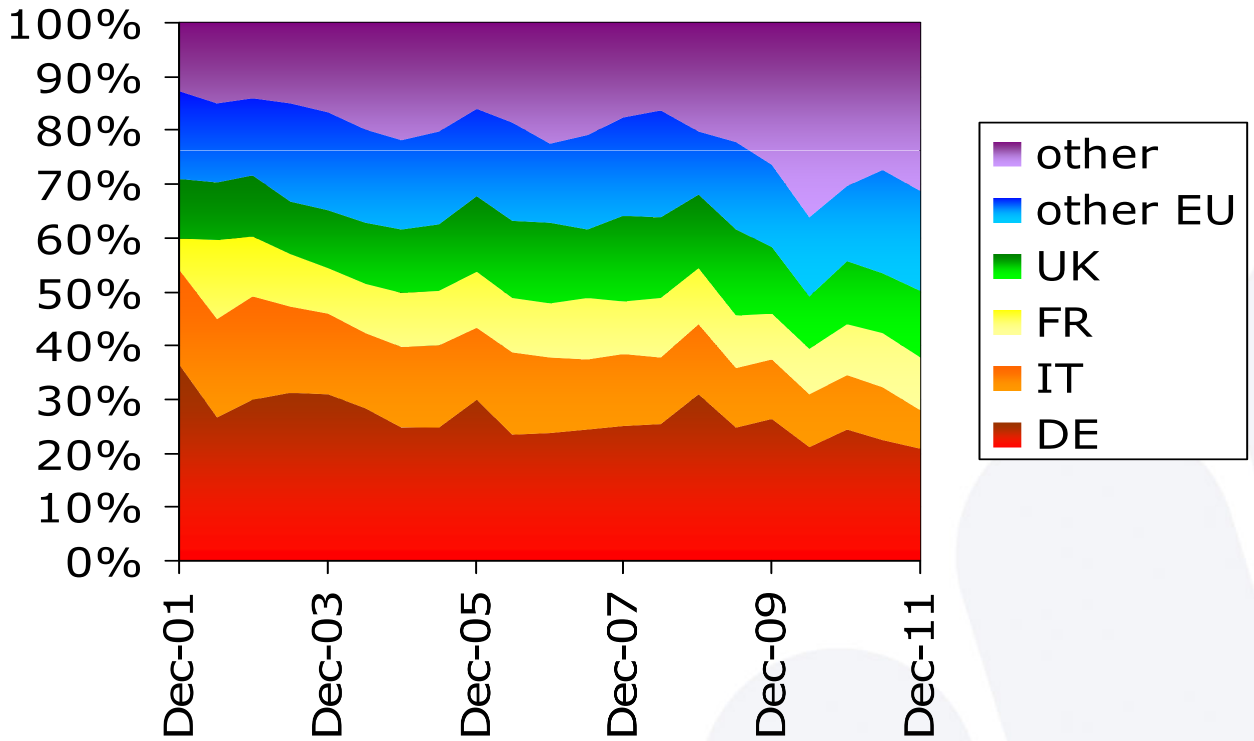
Currency analysis



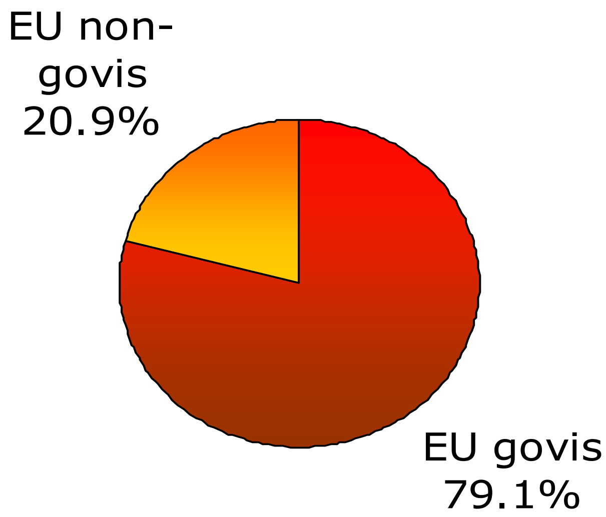
Collateral analysis



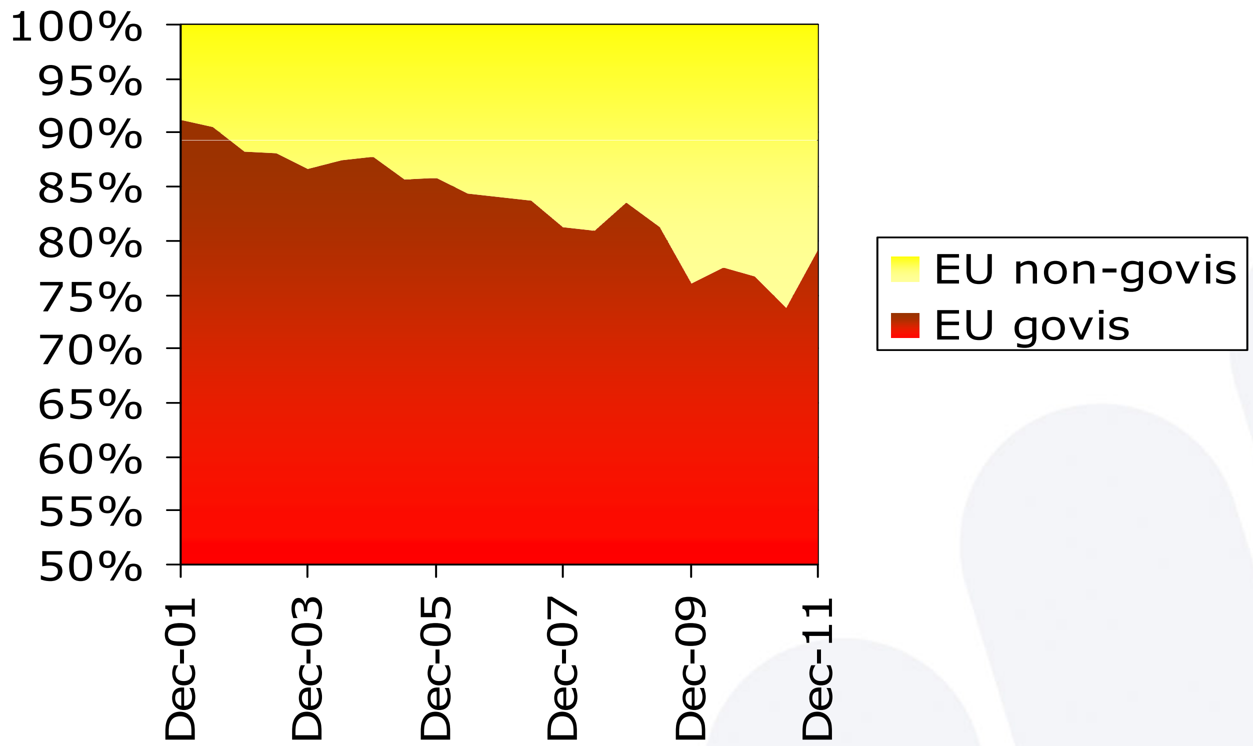
Collateral analysis



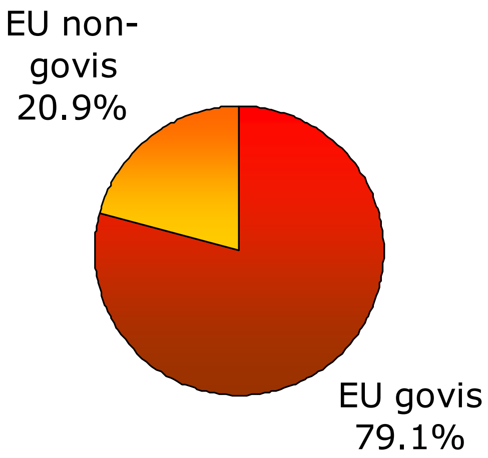
Collateral analysis



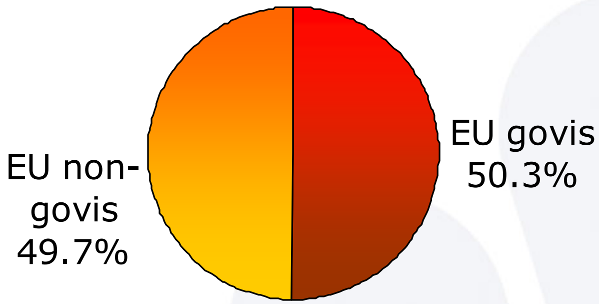
Collateral analysis



Collateral comparison

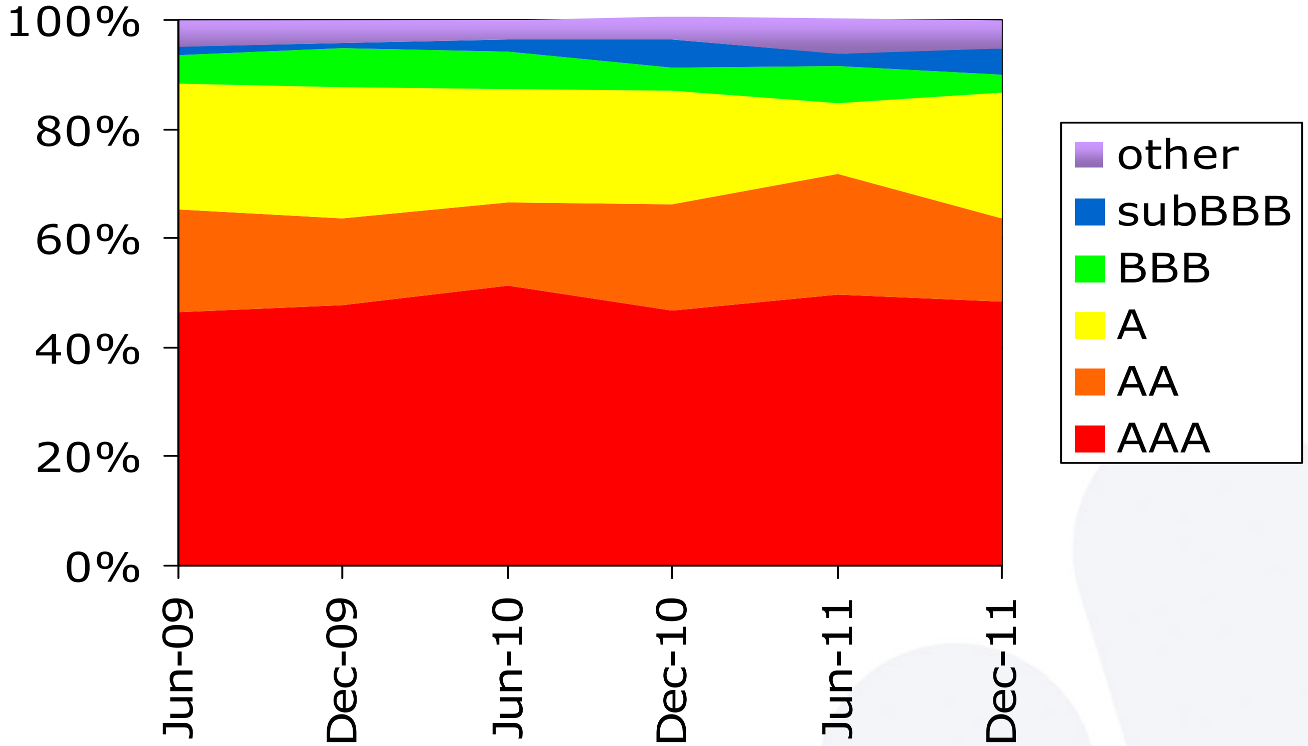


banks

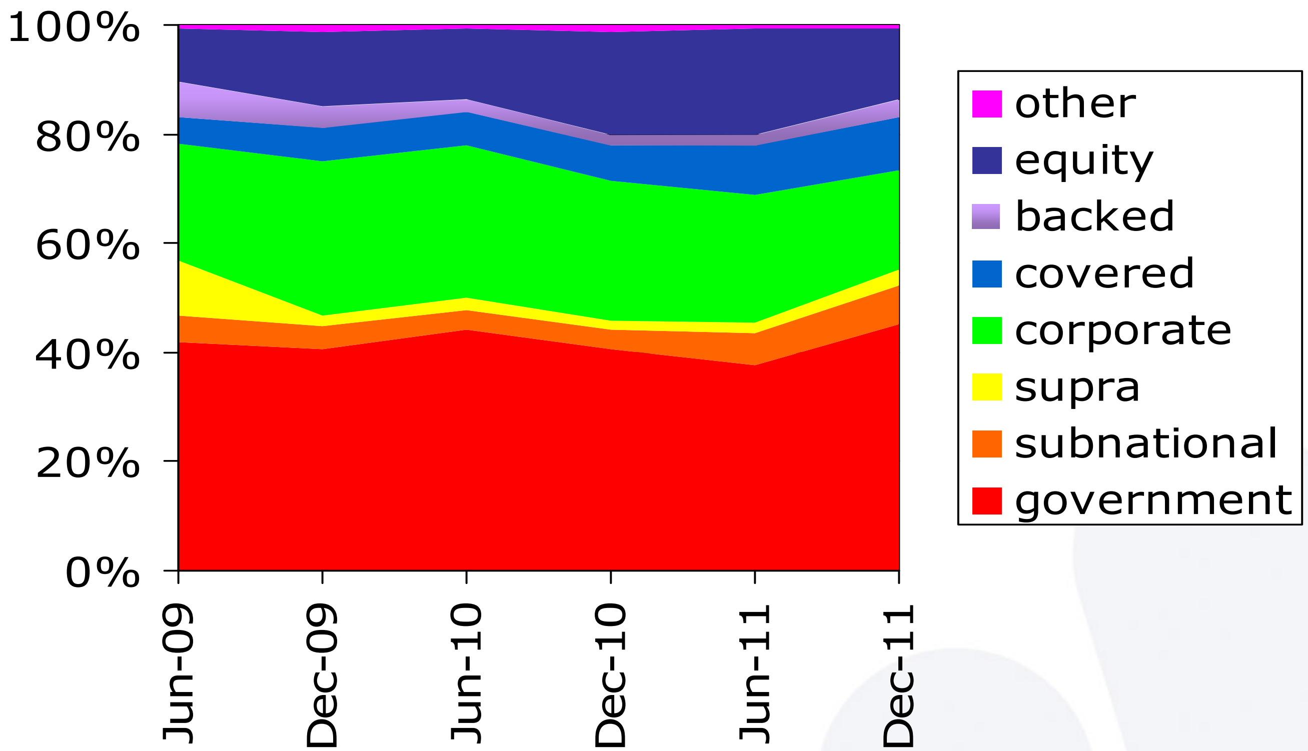


tri-party

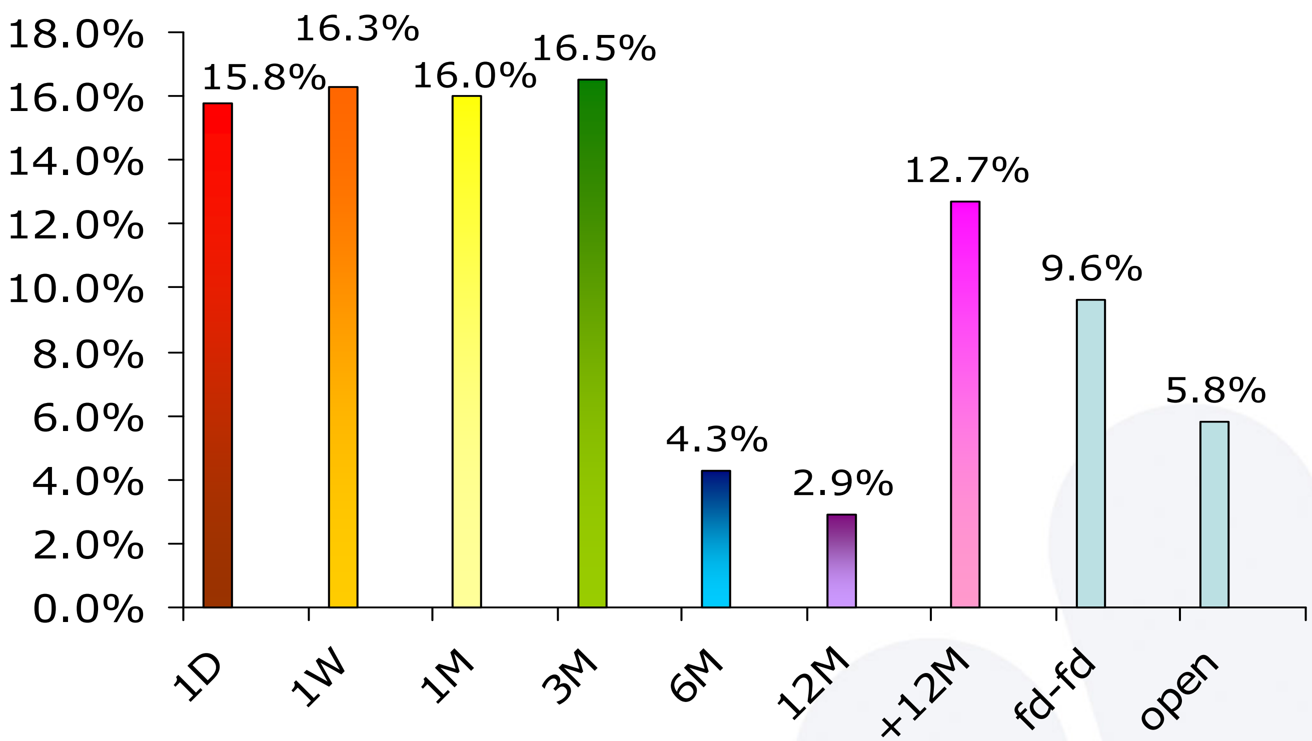
Collateral analysis (tri-party)



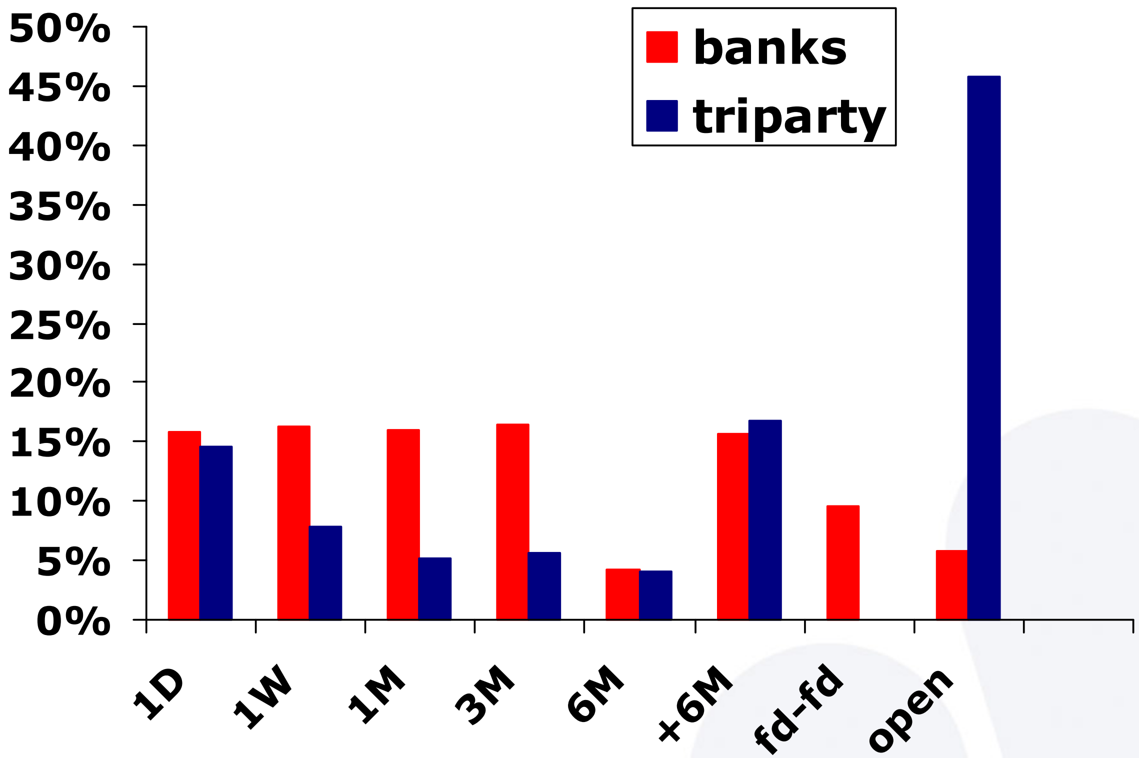
Collateral analysis (tri-party)



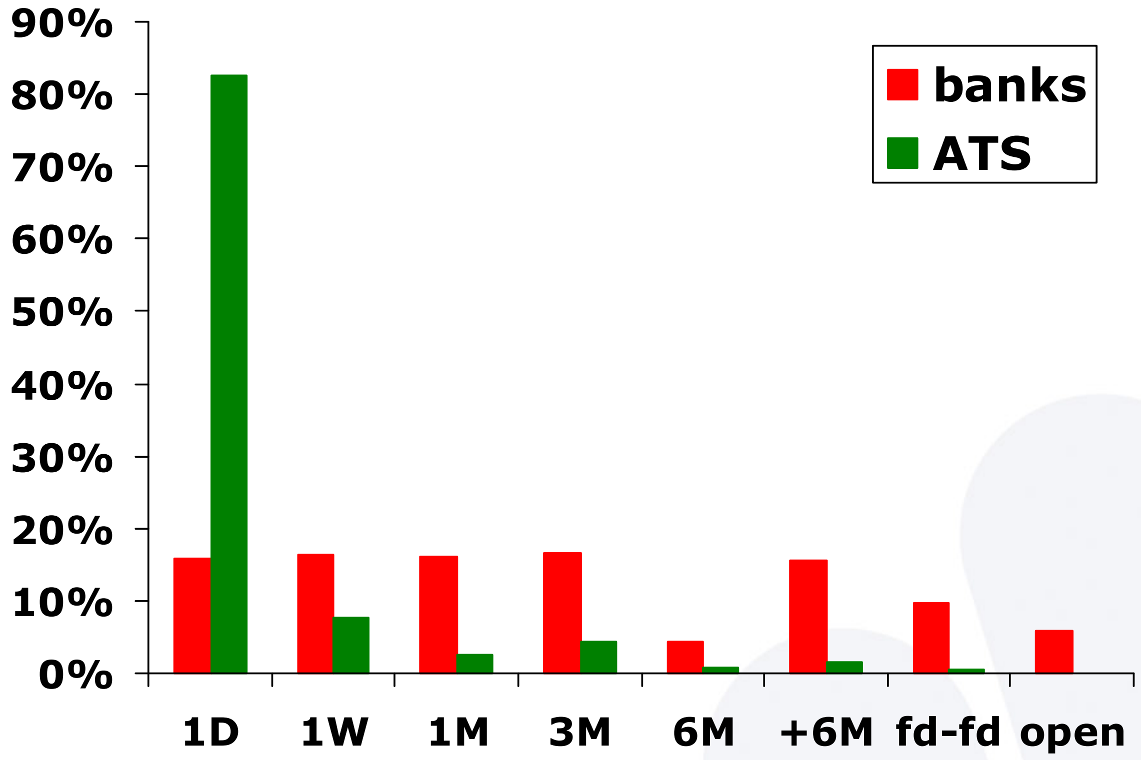
Maturity analysis



Maturity comparison



Maturity comparison



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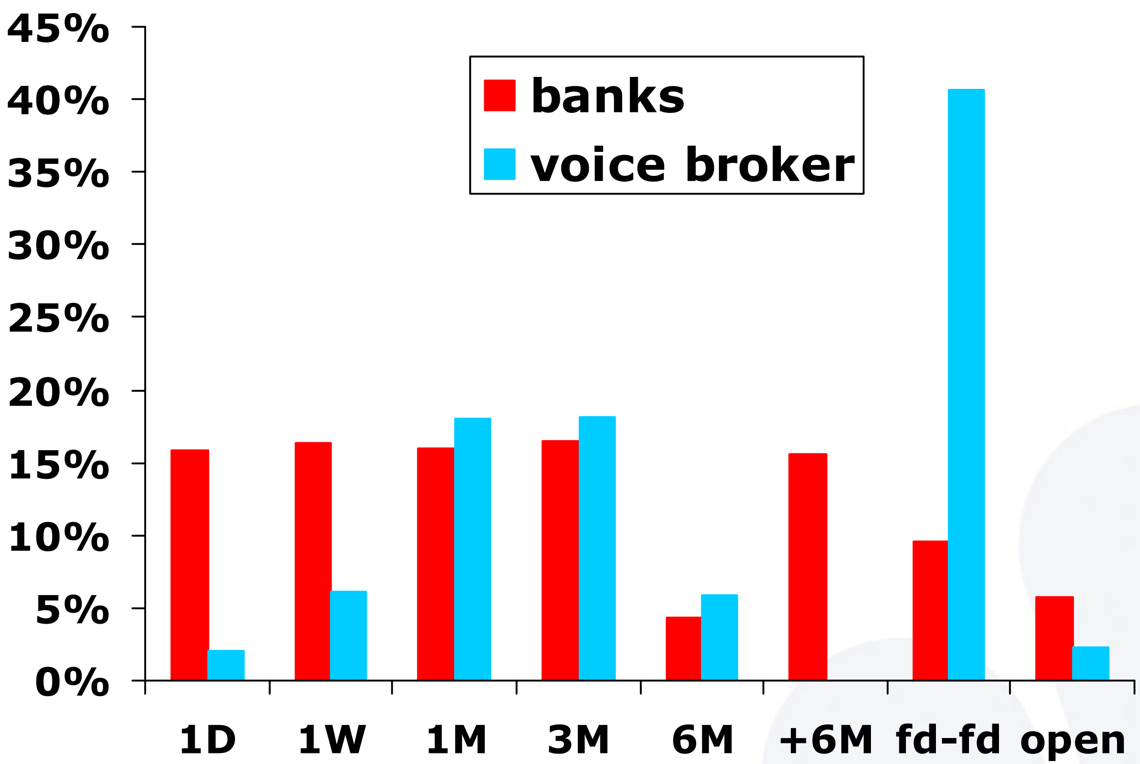
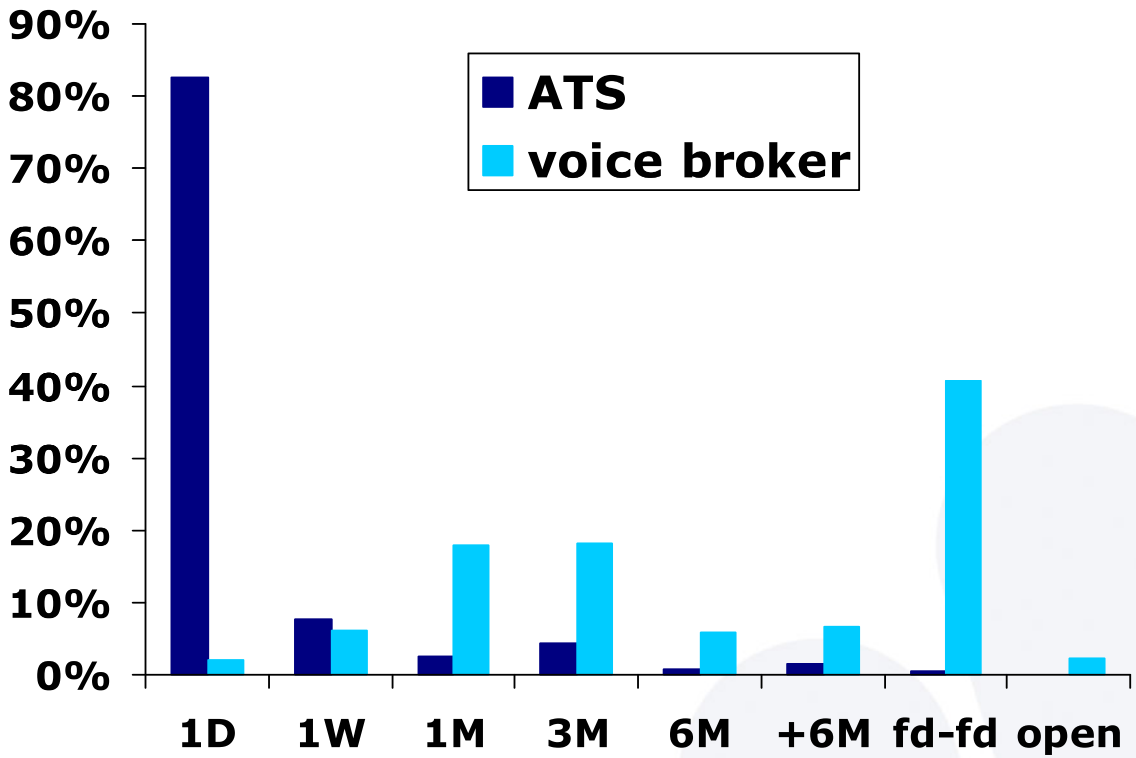
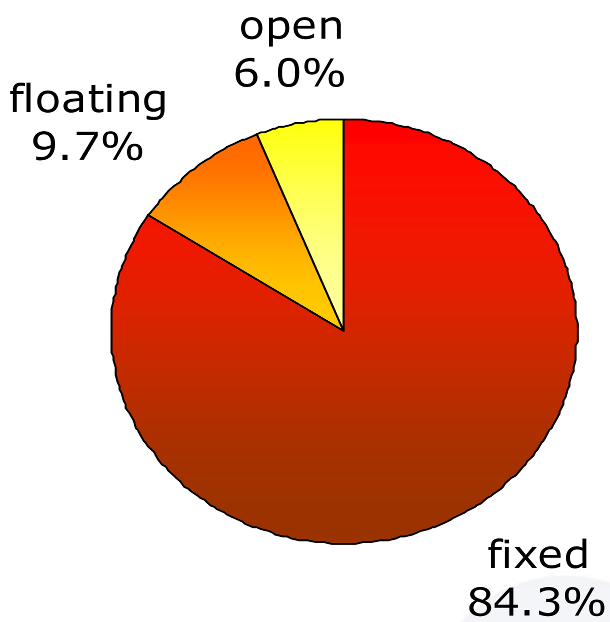


Maturity comparison

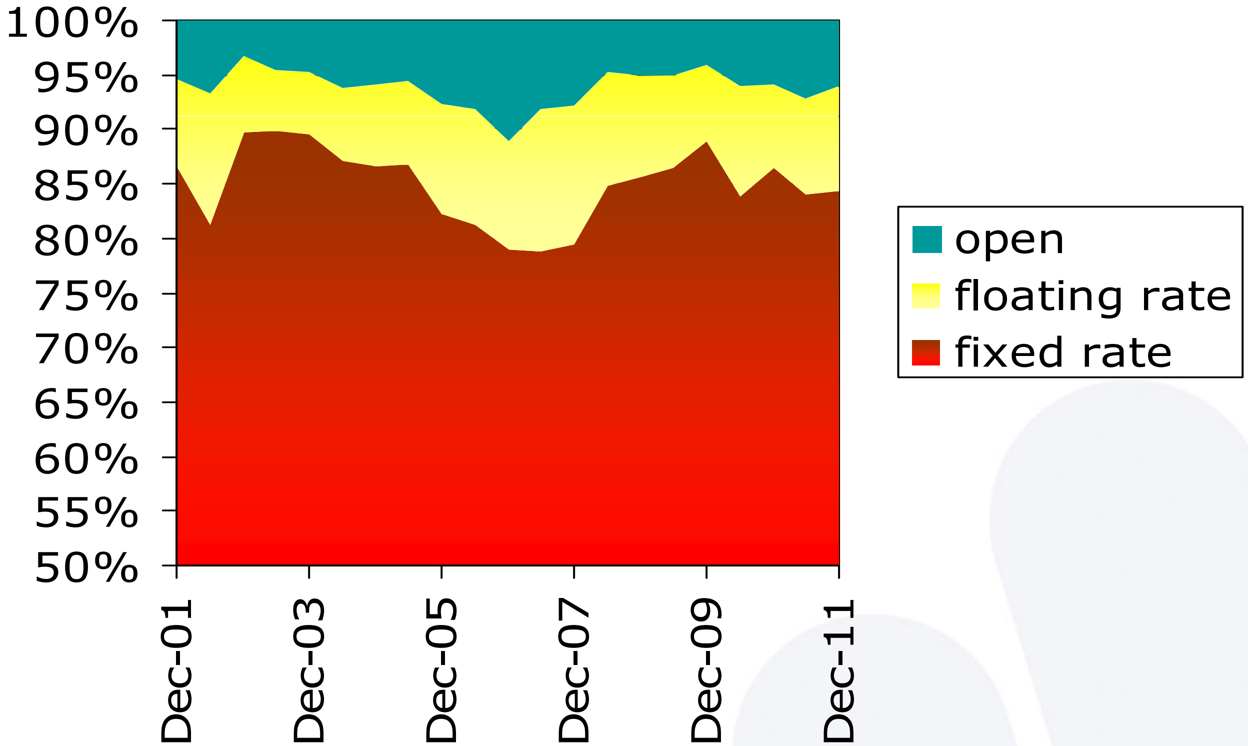


22nd European repo market survey conducted in December 2011

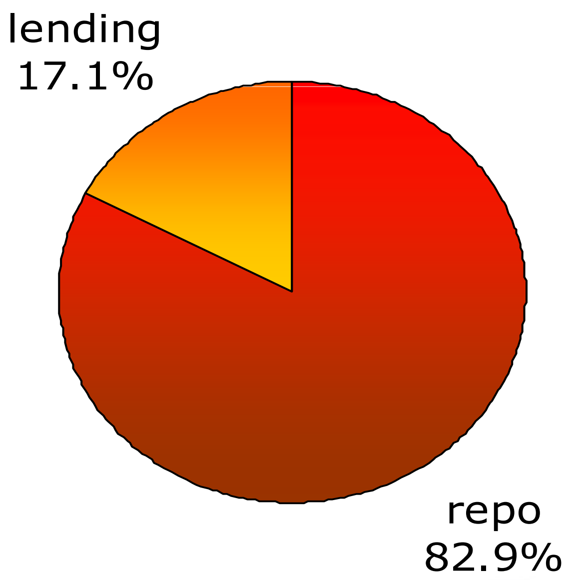
Rate analysis



Rate analysis



Product analysis



Next survey

Wednesday, 13th June 2012

ICMA

International Capital Market Association

Next meetings

An ERC general meeting will be hosted by Nomura on the afternoon of 27th September 2012