Minutes of the European Repo Committee meeting held on 11 October, 2012 in Frankfurt

Present:
- Mr. Godfried De Vidts (Chairman)
- Mr. Simon Kipping
- Mr. Eugene McGrory
- Mr. Grigorios Markouizos
- Mr. Andreas Biewald
- Mr. Romain Dumas
- Mr. Ronan Rowley
- Mr. Olly Benkert
- Mr. Jean-Michel Meyer
- Mr. Stefano Bellani
- Mr. Ulf Bacher
- Mr. Michel Semaan
- Mr. Sylvain Bojic
- Mr. Guido Stroemer
- Mr. Eduard Cia

On the phone:
- Mr. Herminio Crespo Urena
- Mr. Tony Baldwin
- Mr. Edward McAleer
- Ms. Lisa Cleary

Also Present:
- Mr. John Burke
- Mr. Rajen Patel
- Mr. Tony Platt
- Mr. Richard Comotto
- Mr. David Hiscock

Apologies:
- Mr. Stephen Malekian

Welcome by the Chairman

The Chairman thanked Mr. Rowley and Deutsche Bank for hosting the meeting and those Committee members who were in attendance and on the phone.
1. Minutes of the previous meeting

The draft minutes of the last meeting, held on June 19th 2012 in Madrid were unanimously approved by the committee without comment. These minutes will now be published on the ICMA website with unrestricted access.

2. Low and negative interest rate repos

The Chairman briefly introduced the topic, noting that the Committee has considered the topics of fails and settlement incentives over many years. Whilst settlement fails rates currently seem to remain at manageable levels, the increasingly low to negative interest rate environment dictates that it makes sense to revisit these topics and deliberate if there is any current need to reassess agreed practices. The ERC Operations group will have a focus sub-group to spend some time on related thinking and there should be discussions with the CCPs, as in the case of that now organised with LCH.Clearnet. As invited by the Chairman, Mr. John Burke then reviewed a presentation concerning LCH.Clearnet’s thinking on settlement fail incentives in a low/negative interest rate environment.

Mr. Burke explained that LCH.Clearnet’s Fixed Income service has maintained consistently good levels of settlement performance since its launch in 1999; but good settlement performance should not be taken for granted and needs focus to ensure that it is maintained. In 2008 the problem of “widespread and persistent settlement fails” in the US was noted. In the US the response to this problem was a set of TMPG (Treasury Market Practices Group) recommendations. In Europe LCH.Clearnet’s Fixed Income Product Advisory Group (“PAG”) felt that the situation was fundamentally different. Nevertheless, an outline penalty framework was agreed in principle by the PAG, but it was also agreed that it did not need to be implemented at that time.

Mr. Burke went on to explain that different market segments show different fails rates, reflective of local practices. Fails into LCH.Clearnet in Spain and Italy have been consistently higher than elsewhere, although it is hoped that recent changes instigated in Italy by Monte Titoli will help to improve things; and it is hoped that other changes related to Iberclear usage in Spain will also help. Nevertheless, it is considered that the current low/negative rate environment in Europe increases the likelihood of rising fails rates; whilst it is LCH.Clearnet’s desire to maintain appropriate levels of settlement in spite of the environment. It was noted that Mr. Comotto’s work on the ERC White Paper has detailed ERC concerns with the arrangements for settlement in Greece, Italy and Spain amongst others, resolution of which should continue to be pursued by the ERC.

Mr. Burke explained that LCH.Clearnet accordingly has an outline model for a penalty framework in place. This aims to maintain an incentive to settle, which is naturally the case with higher rates but absent such rates needs replacement by another incentive. The first part of the framework considers the trigger for when penalties might be applied. It has been decided that a simple and fair approach is to monitor nominal fails rates (of Dealers delivery of securities to LCH.Clearnet) over a given time frame, across different market segments. Monitored threshold levels serve as a trigger for the PAG to determine if it is appropriate to instigate penalties, which should ideally be done in alignment with the market. LCH.Clearnet has identified its objectives in potentially applying penalties, which expressly do not include that LCH.Clearnet should make a profit (or loss). Penalties could apply to all fails regardless of the underlying repo rate, but would target worst settlement performers in a segment.
Furthermore LCH.Clearnet has elaborated a set of process steps to assure that if the trigger condition is met there will be appropriate monitoring, escalation and application of penalties until acceptable settlement levels are re-attained. The penalty rate could follow the TMPG formulation under which Penalty rate % = \( \text{Max} (3\% - \text{Reference Rate value}, 0) \). LCH.Clearnet’s hope is that the threat of penalties will help ensure that in practice the penalties need never to actually be triggered and applied; and seek to raise market awareness of their framework to ensure that the threat is properly appreciated.

It was noted in discussion that the European Commission’s proposed CSD Regulation includes proposals for penalties as well as for buy-ins. The details of this regulation remain to be resolved, with the European Parliament already having proposed amendments to the operation of the buy-ins. These elements need to remain under review by the ERC alongside the evolving position of CCP’s, as illustrated by the description of LCH.Clearnet’s framework. The ERC should clarify its position, also taking account of the discussions being organised by the ERC operations Group; and in coordination with AFME’s post-trade group. Mr. Comotto, who is already looking at currently stated ERC practice, will remain closely involved in the ERC’s efforts in this regard.

It was also noted that market behaviours inevitably evolve in response to all applicable factors. There is some risk that too harsh a penalty regime could impede the market and it is important to continue to focus upfront on the question of why fails occur. Only then can changes be targeted at correctly fixing any underlying causal factors. Other options such as mini close-outs, as provided for by the GMRA, can provide flexibility to market participants, but the role of CCPs means that they must act under a different set of constraints than those faced in the bi-lateral market.

3. Other LCH.Clearnet related points

The Chairman asked Mr. Burke about progress with the request for LCH.Clearnet to use the full/dirty price when crediting collateral that is posted to margin? Mr. Burke explained that the change depends upon first updating legal documentation to ensure that all amounts are adequately protected in case of default. Were this just a change applicable to RepoClear it should have been relatively straightforward to put in place, but rather it is the case that all of LCH.Clearnet’s business is impacted. This has led to extensive, time-consuming and highly detailed legal discussions. As documentary changes are costly and only occur periodically, the aim is to ensure that just one documentary change occurs, capturing both this change and some other points of improvement in legal arrangements. It does now appear that the work on this is nearing conclusion and should be that resolution on the documentation will be reached within the next 10 days.

Noting that there seems to be some migration of business to the bi-lateral market, the Chairman asked whether LCH.Clearnet’s margins might now be set too high? Mr. Burke explained how LCH.Clearnet goes about setting its margins to appropriately manage the risks it receives. This includes elements which make margins higher for some participants than others, dependent on wrong-way risk considerations; on the details of the collateral provided; and the size of the position. Overall margin levels are influenced by the size of the default fund, which reflects the mutualised risk position of the clearing members. Also, LCH.Clearnet work on a defaulter pays basis, which relatively higher margins help to achieve. CCP risk management is not synonymous with that of bi-lateral market counterparties, so it is inappropriate to simplistically compare CCP margin levels with those for bilateral trades.
There was ensuing discussion of the role which many Committee members’ own firms play in establishing LCH.Clearnet’s risk management policy, including in the establishment of the desired size of the default fund. It was noted that LCH.Clearnet has been reorganising to segregate the default fund for its RepoClear activity from those for its other clearing activities. Mr. Burke also explained that LCH.Clearnet is developing new tools to transparently enable firms to fully understand how their margins are being derived; and which risk reduction strategies would allow them to minimise their margin requirements.

Discussion also noted the impact of central bank policies on firms’ chosen liquidity management strategies, but it was stressed that the frame of reference under which central banks are setting haircuts is different again from those of CCP’s and bilateral markets. Mr. Burke finally noted that certain system enhancements are in hand, which should, particularly in the case of gilt margins, lead to reductions in margin levels through improvements in the possibilities for margin offsets.

On a final point, the Chairman asked why floating rate bonds are not accepted by LCH.Clearnet? Mr. Burke responded that this is primarily related to the relatively illiquid nature if floating rate bonds. Again though, technology upgrades are being made which should allow LCH.Clearnet to better handle floating rate bonds (and various other instruments), which should lead to possibilities for the acceptance of the most liquid of floating rate bonds.

The Chairman thanked Mr. Burke for all his helpful contributions to the discussion and noted that discussions will also be held with other CCPs. As such the Chairman reported that he hoped, working in conjunction with EACH (European Association of CCP Clearing Houses), to organise an open meeting amongst the different CCPs in early 2013.

4. Criteria for membership of the ERC

The Chairman invited a discussion about the nature of the membership criteria for the ERC as currently established in the ICMA rules and recommendations. Ms. Cleary explained that amongst other criteria for becoming a member of the ERC it is required that “the applicant has, or has undertaken to commence, a dedicated repo activity”. There was a discussion about the meaning of the phrase “dedicated repo activity”. It was agreed that this topic would be revisited at the next scheduled Committee meeting, on 4 December.

5. Committee meeting with the ECB

The Chairman drew attention to the agenda for the meeting between the ERC Committee and representatives of the European Central Bank (ECB), which was scheduled to take place in nearby ECB offices directly after the conclusion of the Committee’s own meeting. This agenda included three major points:

1. Discussion of latest repo developments and an update on the state of the repo market;
2. Discussion of increased demands for collateral and collateral availability issues; and
3. Discussion of the consequences of legislative developments impacting the repo market.
In preparation of their thoughts for the upcoming ECB meeting, the Committee then shared thoughts on each of these major points. Particularly noting that there have been some personnel changes in the ECB team, the Chairman emphasised the importance of this dialogue in allowing the ECB, as has been the case in the past, to hear honest opinions of the repo market at first hand.

6. ERC Operations Group update

Mr. Platt noted that on 15 October members of the Group would be meeting with representatives of the two principal European ICSDs. The object of this meeting is to obtain a clear appreciation of the impact on the ICSDs provision of services, particularly including triparty, in case the European Commission’s CSD Regulation proposals are enacted and the ICSDs are thus forced to split their provision of securities and cash (banking) services.

Mr. Platt also reported that two focus sub-groups have been established following the Group’s last meeting, one to explore the question of best practices for fails (in both negative and positive rate environments) and the other to take a more detailed look at the implications for repo of TARGET2-Securities. Each of these sub-groups will have their first meetings in the coming weeks.

7. AOB and upcoming dates

The Chairman drew the meeting to a close, calling for the other items proposed for the agenda to be rolled over to the Committee’s next scheduled meeting. This will be at 15:00 (UK time) on 4 December, hosted in London by HSBC. A dinner for Committee members will be hosted by ICMA, following on from the meeting.

The Chairman proposed that the subsequent meeting should take place in Luxembourg on the afternoon of 16 January 2013, alongside the Clearstream conference. It was also suggested that a Committee meeting should be arranged to take place in Paris on 11 March 2013, following on from the ERC AGM and the election of the new Committee. The Chairman noted that a Committee meeting may also be arranged in Copenhagen, alongside of the ICMA’s AGM and annual conference, which is scheduled for 22 – 24 May, 2013.

It was also noted that the next Professional Repo and Collateral Management Course will be held on November 20 – 21 in London, hosted by Fitch.