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EUROPEAN REPO AND COLLATERAL COUNCIL

Minutes of the General Meeting of the ICMA European Repo and Collateral Council (ERCC) held on 14 November 2017, in Brussels

Host: Euroclear
Location: The Square, Ravensteinstraat 2, 1000 Brussels, Belgium
Time: 14:00 - 17:00 CET

Member firms represented at the meeting: Please see Annex A.

1. Welcome remarks by the ICMA ERCC Chairman

Mr. Godfried De Vidts, Chairman of the ICMA ERCC, welcomed all attendees and thanked Euroclear for hosting the event. He explained that the overarching theme of this year's AGM was reflected in the event's title "De-mystifying Repo: Impacts on Financial Stability and the Real Economy". The aim will be to address some of the persistent (mis)perceptions about the Repo market that have surfaced in the public domain since the crisis and to have an open and honest debate about the role and the real economic impacts of Repo. To do this it was decided to follow a somewhat different format from previous editions, with two well-balanced panels including representatives from both private and public sector, framed by keynote speeches by two senior public sector officials. [See presentation, slides 1-10]

2. Opening Keynote Address: Monetary Policy and the Repo Market in the Euro Area

Mr. Mahmood Pradhan, Deputy Director, European Department, International Monetary Fund, provided the opening keynote address, focusing on the important linkages between "Monetary Policy and the Repo Market in the Euro Area". [See presentation, slides 11-21]

3. **Panel 1: Macro-financial Linkages of Repo Markets and Financial Stability Implications**

Moderator:
Mr. Andreas Jobst, Adviser to the Managing Director and CFO, World Bank

Panellists:
Mr. Peter Grasmann, Head of Unit E1, Directorate E, DG FISMA, European Commission
Mr. Steffen Kern, Head of Risk Analysis and Economics Department, ESMA
Mr. Michael Manna, Head of Fixed Income Financing Trading Europe, Barclays
Mr. Alberto Gallo, Head of Macro Strategies, Algebris

Mr. Jobst introduced the panellists and outlined the agenda for the panel. The objective was to explore the macro-financial implications of the changes in the European repo market and its capacity to support collateral availability against the background of regulatory reforms and unconventional monetary policy. The discussion was structured around four major themes.

In a first part, panellists reviewed the **key aspects of the post-crisis narrative on repo markets**, and how this squares with the current view of repo markets. Mr. Manna commented that repo markets have clearly come a long way since 2008, when they were seen by many as the "smoking gun" of the financial crisis. Important lessons have been learnt and regulation, in particular liquidity and leverage requirements, have helped bring more stability and reduce problematic funding mismatches, in the context of an overall more robust financial system. As a result, repo has become an important stabilizing force for the financial market - an evolution that could almost be described as one from "sinner to saviour". In particular, Mr. Manna highlighted the important role of repo in the transmission of (unconventional) monetary policy, and as a stabilizing factor in the 2011/2012 sovereign debt crisis in Europe, the 2017 bank bail-outs, and most recently, during the Catalonian crisis. Mr. Gallo agreed that many of the previously identified vulnerabilities have indeed been addressed since the crisis, but also cautioned that new risks and imbalances might have been created in this process in other parts of the market. In particular, he pointed to the effects of the persistently very loose monetary policy stance over the past years, which has triggered imbalances in investment strategies in the market, many of which seem dangerously reliant on a continued low interest rate and low volatility environment. This could become a source of instability during a period of monetary normalization and will require close attention. From a regulatory perspective, Mr. Grasmann commented that while repo was certainly not at the core of the post-crisis regulatory agenda, some important issues with the market have been identified that need to be and are being addressed. Examples include the lack of transparency as well as the scarcity of safe collateral. The latter has become apparent since the crisis as risk perceptions have changed, highlighting the dispersed nature of collateral markets in Europe. In this context, Mr. Grasmann also briefly commented on the Commission's recent work on corporate bond markets, which remain much more fragmented in Europe than in other major jurisdictions. Mr. Kern concluded this part of the discussion, commenting on the various facets of the repo market. Given the substantial size of the market and its importance at the heart of the financial system, in particular its role as a bridge between the banking sector and the various non-bank actors, it is quite striking from a regulator's perspective that the market is still relatively little understood. This lack of transparency is something that they hope to address through the adoption of the SFT Regulation, with reporting expected to start in 2019.

Panellists moved on to the **implications of financial regulation**, **in the context of an extremely low interest rate environment.** Building on his previous intervention, Mr. Kern commented that the two key issues in relation to repo that ESMA is trying to better understand are pro-cyclicality and inter-connectedness, especially the ways in which repo facilitates the increase non-bank leverage. There are already regulatory tools that allow them to monitor the latter and address it at the level of individual non-bank entities, but one question to be considered going forward will be whether additional tools are required to intervene directly in the market, e.g. through minimum haircut floors. Previous analysis indicated that haircut levels in Europe are already above levels recommended by the FSB, which provided some comfort. However, this question will be reconsidered once the SFTR data is available. On this issue, Mr. Manna expressed some support for the idea of regulatory intervention to prevent firms from using haircuts as a competitive tool (which seemed to be a greater concern than excessive haircuts during times of market funding stress). He also said that he fully supports the objectives of SFTR but cautioned that the challenge for regulators to make valuable use of the extensive data should not be underestimated. On an aggregate basis, Mr. Grasmann said that it is probably still too early to assess the full impact of regulation, as the regulatory agenda continues to be rolled out and given the persistent low interest environment. However, he was cautiously optimistic that firms will adjust without major problems to the new environment, even in a context of monetary policy normalization. One reason for optimism that is sometimes not sufficiently appreciated is the fact that this adjustment is likely to happen in a more favorable overall economic environment. Regulation has clearly helped create a more robust system and at this stage he sees no need for a renewed regulatory push, as many of the risks in the market would appear to be part of the normal market functioning. Based on a set of slides (see p.23-32), Mr. Gallo commented on some of the key risks that Algebris currently see in the market, especially on the asset management side. As a side-effect of QE, they see a large number of strategies that rely on extremely low levels of volatility. The worry is that as monetary policy normalizes and volatility returns, unwinding these strategies might be problematic, reinforce volatility and lead to market disruption. Mr. Manna agreed that the key risks are probably to be found on the buy-side, as regulation has led to a clean-up of banks' balance sheets. Mr. Grasmann agreed with the fact that buy-side balance sheets now look more vulnerable, cautioning though that this shouldn't lead regulators to jump to the conclusion that asset managers should be subject to the same prudential requirements as banks. The distinction is still justified by structural differences, in particular the greater systemic importance of banks on average. Mr. Kern commented on the important role of repo in this context from a supervisory perspective. Assuming that interconnectedness between banks and non-banks has increased through repo, this is likely to result in a more immediate feedback loop in case of a crisis than previously seen, something that ESMA is closely watching.

The panel subsequently focused on the implications for the repo market of **monetary policy implementation.** Mr. Manna commented that overall the implementation of monetary policy in Europe hasn't destabilized markets. Initially the market faced some issues due to insufficient and fragmented securities lending mechanisms offered by central banks. However, these have been gradually improved and are now fulfilling their supportive role. In relation to concerns with a scarcity of safe collateral in Europe, Mr. Manna remarked that the real problem in Europe was in his view not an insufficient availability of suitable assets, but rather the fragmentation of collateral markets in Europe caused by political reluctance in relation to risk sharing and credit spreads implied by risk perceptions in the market. Mr. Gallo agreed and added that a more ambitious CMU project would certainly go a long way towards solving problems with collateral scarcity in Europe.

In a final round of interventions, panellists commented on the **importance of a resilient and more efficient market infrastructure in Europe, in particular CCPs, and the role of FinTech**. Regarding CCPs, Mr. Kern noted a significant increase of repo clearing over the past couple of years. While this development is fully in line with regulatory objectives, he also stressed that this has been driven essentially by the market and not by regulatory requirements. Other panellists confirmed that CCPs now play a fundamental role in the market and saw this generally as a positive development. However, they also stressed the challenges related to the increasingly systemic role of CCPs, creating new "too big to fail" issues and raising questions in relation to appropriate backstops. In relation to FinTech, panellists all agreed that this was an area to watch closely as technology is set to reshape the market over the next years. One of the challenges for FinTech specifically related to Repo will be to create sufficiently scalable solutions given the size of repo markets. From a regulatory perspective, FinTech is already a priority today that is closely monitored. Mr. Grasmann remarked that for regulators FinTech is also to some degree a game changer, and they have to be very careful not to stand in the way of innovation.

Panel 2: Post-crisis Regulatory Reforms and the Functioning of Repo Markets

Moderator:
Ms. Natasha de Teran, Head of Corporate Affairs, SWIFT

Panellists:
Mr. Richard Hochreutiner, Director, Head Global Collateral, SwissRe
Mr. Benedict Roth, Senior Technical Specialist, Prudential Policy, Bank of England
Mr. Greg Markouizos, Global Head of Fixed Income Finance & Collateral Management, Citigroup
Mr. Richard Comotto, Senior Visiting Fellow, ICMA Centre

Following introductions, Ms. De Teran set out the agenda for the panel. Following up on the discussion of the first panel, the objective was now to look at some of the regulatory initiatives more in detail and to assess their impact on repo markets.

In a first part, Ms. De Teran asked panellists to share their views on the **Leverage Ratio (LR)**, given that this had been cited previously by ICMA as the single most important factor impacting repo market functioning[1]. Mr. Markouizos confirmed this assessment, explaining that the LR by its nature is a very blunt instrument, imposing a cost on balance sheet size. For repo as a low margin, balance sheet intensive business, this has become the binding constraint which has led firms to dramatically cut their repo balance sheets. Despite the substantial immediate effect, Mr. Markouizos also added that the impact has been somewhat mitigated over the past 18 months as firms have adjusted their business models and as regulators have shifted their focus to risk-based capital measures. Mr. Roth confirmed the impact of the LR on repo business, which was very apparent from feedback gathered

[1] See e.g. ICMA Report: *Perspectives from the eye of the storm: The current state and future evolution of the European repo market* (November 2015)

from market participants in the context of the April 2017 CGFS report on *Repo Market Functioning*. From a buy-side perspective, Mr. Hochreutiner added that it is difficult for them to assess where the main pain points for their bank counterparts lie. However, it is clear that buy-sides are facing problems, caused by a variety of factors that restrain the banks' ability to fulfil their vital role as market makers. This has been especially visible in the 2016 year-end dislocations, but buy-sides are generally watching repo market developments with some concern as the repo market fulfils several vital functions for them. However, if the market becomes less reliable as a source of funding then buy-side firms will be forced to look for alternatives.

Panellists then turned to the **Liquidity Coverage Ratio (LCR)**, which compared to the LR has had a more muted impact on the repo market and has generally been accommodated quite well. In fact, Mr. Markouizos explained that despite some unintended consequences, the overall effect from LCR on the market has been rather positive as this has led firms to focus more on their short-term funding needs, thereby decreasing liquidity risk for the market as a whole. From a buy-side perspective, another positive effect of the LCR has been an increasing focus on the value of liquidity. This has created yield enhancement opportunities for buy-side firms who have been able to monetize the liquidity of their HQLA assets.

Another regulatory requirement which, although not yet fully implemented, is expected to have a major impact on the repo market is the **Net Stable Funding Ratio (NSFR)**. Once implemented, this might well become the next major challenge for the repo business. Mr. Roth explained the logic of the NSFR from a regulatory perspective, namely that some level of stable funding is required even for a book which is contractually-matched. Although regulators generally agree that some level of stable funding is required there are still major discussions as to what the appropriate level of required funding should be. As a result, the implementation of NSFR may differ across jurisdictions. Mr. Markouizos agreed with the logic of NSFR but explained that this only applies for certain types of repo, namely when used for client funding, not for other repo, used e.g. to move collateral. As such distinction is difficult to achieve in practice, the current blunt NSFR requirement results in a lower than optimal weighting applied to a much larger universe of trades than appropriate, which of course leads to distortions.

Another major headache for the repo market is the upcoming **CSD Regulation (CSDR)**, in particular the settlement discipline provisions included therein. If implemented as proposed, mandatory buy-ins are likely to introduce significant risks and threaten to disrupt markets. The implications are expected to be particularly severe for repo market makers, given the low margins involved and might lead some of them to retreat from the market. This might well pose an existential threat to liquidity and would have an immediate impact on cash markets. Mr. Comotto highlighted some further problems with mandatory buy-ins which have received less attention so far, in particular the risk that repo netting sets will have to be split given the exemption for short-term repo. Overall, he said that mandatory buy-ins seem to be a solution looking for a problem, given that settlement efficiency in Europe has not been identified as problematic so far and certainly does not justify the consequential risks that come attached to mandatory buy-ins.

Panellists then turned to the challenges with the upcoming **SFT Regulation (SFTR)**. All panellists agreed with the basic objectives of SFTR, namely to overcome a lack of transparency in SFT markets, stressing that this will also ultimately help the market to counter some of the persistent myths and misperceptions about repo. However, panellists also raised concerns with the way the SFTR tries to achieve this objective. Mr. Hochreutiner commented that position level reporting would have been a more efficient and straightforward way to provide regulators with the relevant information. Instead, the SFTR imposes an extensive trade-by-trade reporting regime which will be burdensome for users to implement and difficult for regulators to make use of.

Moving away from individual pieces of regulation, panellists discussed initiatives to extend CCP-clearing of repo to buy-side participants, and how far this might help alleviate some of the problems in the market as regulatory constraints force banks to step back from their vital role as market makers. Panellists noted a number of relevant products that have been launched by CCPs over the past years, both in Europe and the US. However, so far these have had only limited success. Mr. Markouizos said that by their very nature CCPs can bring down systemic risk through netting but also cautioned that in certain scenarios the resulting risk concentration creates problems that may outweigh these benefits. In particular, this is likely the case where products are introduced that are not suitable for CCP-clearing, and many buy-sides are looking at precisely such products for clearing purposes. Furthermore, CCPs have to use very sophisticated and far-reaching risk management tools. For users it is critical to fully understand these tools to be able to manage the related risks appropriately. Many buy-side firms do not currently have this capacity. Given the risks involved, it is important to carefully consider easier, more targeted solutions to the underlying problem that the buy-side clearing initiatives aim to address, which is buy-side market access. From a regulator's perspective, Mr. Roth agreed that it would be dangerous to introduce products other than the most liquid ones into CCPs and that the technical requirements to become a member of a CCP, e.g. in terms of managing risk and margin calls, are indeed often underestimated. Mr. Hochreutiner commented on the challenges for buy-side firms to become a CCP member. While market access was clearly an issue, he pointed out that most buy-side firms are unlikely to benefit significantly from CCP netting as their positions are essentially one-sided. Given the challenges, he was generally sceptical whether the benefits for the buy-side justify accepting the huge potential exposure that comes with the concentration of risk in the CCP. Mr. Comotto commented that it is clear from recent market developments that there is an important place for CCP-clearing in the repo market with a market share of now 60-70% (in terms of turnover). While he remains sceptical whether direct buy-side clearing will soon gain significant traction, he also noted a new generation of very sophisticated client clearing models which are trying to address some of the problems mentioned. It will have to be seen whether these can change the overall assessment related to buy-side access to CCPs.

4. <u>Closing Keynote Address:</u> Asset purchases, financial regulation and repo market activity

Mr. Benoît Cœuré, Member of the Executive Board, European Central Bank, provided the closing keynote speech focusing on "Asset Purchases, financial regulation and repo market activity".
[The full speech has been published on the ECB website.]

Annex A
The following firms were represented at the meeting:

Abbey National Treasury Services plc
ABN AMRO Bank N.V.
Afore Consulting
Algebris
Allied Irish Bank plc
Asian Prime Collateral Forum
Aurel BGC
Aviva Investors Global Services Limited
AXA Bank Europe s.a.
Banco Bilbao Vizcaya Argentaria, S.A.
Banco BPM S.p.A.
Banco de Sabadell SA
Banco Santander, S.A.
Bangko Sentral ng Pilipinas
Bank for International Settlements
Bank of England
Bank of Finland
Bank of Ireland
Bankia, S.A.
Barclays Capital Securities Limited
Bayerische Landesbank
Belfius Bank & Insurance
BlackRock Investment Management (UK) Limited
Bloomberg L.P.
Bloomberg News
BNP Paribas
BNP Paribas Fortis
BNP Paribas Securities Services
Broadridge Financial Solutions, Inc.
BrokerTec Europe Limited
BSN Capital
Caixabank, S.A.
Canadian Imperial Bank of Commerce London Branch
Centre for European Policy Studies (CEPS)
China Investment Corporation
Citibank, N.A.
Citigroup Global Markets Limited
Clearstream Banking S.A.
Clifford Chance LLP
CME Group, Inc.
Cognizant
Commerzbank AG
Coöperatieve Rabobank U.A. (trading as Rabobank London (RL)

Council of Europe Development Bank (CEB)
Crédit Agricole Corporate and Investment Bank
Credit Suisse Securities (Europe) Limited
Daiwa Capital Markets Europe Limited
Degroof Petercam Asset Management
DekaBank Deutsche Girozentrale
Deutsche Bank AG, London Branch
Deutsche Bundesbank
Dexia Crédit Local
DNB BANK ASA
DZ Bank AG
EquiLend LLC
Eurex Repo GmbH
Euroclear Bank S.A./N.V.
EuroMTS Limited (trading as MTS Markets)
European Capital Markets Institute (ECMI)
European Central Bank
European Commission
European Investment Bank
European Money Markets Institute (EMMI)
European Securities and Markets Authority (ESMA)
European Stability Mechanism (ESM)
Federal Republic of Germany, Finance Agency
Federal Reserve Bank of New York
Financial Conduct Authority
FleishmanHillard
GLMX
Global Capital
HALKBANK
IHS Global SA
Independent
ING Bank
ING Bank N.V.
ING Belgium SA/NV
ING DiBa AG
International Finance Corporation
International Monetary Fund (IMF)
INVESTNEWS/SYSTEMICS
J.P. Morgan (New York)
J.P. Morgan Securities plc
KBC Bank N.V.
Kommunalbanken AS
KPMG LLP
Kreab
Larrain Vial S.A. Corredora de Bolsa
LCH Limited

Les Echos
Lloyds Bank plc
Loyens & Loeff N.V.
M&T Bank
Macquarie Bank Limited
Magyar Nemzeti Bank
MarketAxess Europe Limited
Merrill Lynch International
MN Services N.V.
Mni-news
MUFG Securities EMEA plc
Murex S.A.S.
Nasdaq Stockholm AB
National Bank of Belgium
National Bank of Slovakia
National Settlement Depository (NSD)
Natixis
NBC Global Finance Limited
NEX Group Plc
NFA - National Finance Association
NN Investment Partners B.V.
Nomura Bank (Luxembourg) S.A.
Norges Bank
Northcross Capital LLP
Phinest Consulting
Pirum Systems Limited
Raiffeisen Bank International AG
S.W.I.F.T. SCRL
Santander UK plc
Sernova Financial
Shanghai Clearing House
Simmons & Simmons LLP
SIX SIS AG
Société de la Bourse de Luxembourg S.A.
Squire Patton Boggs (UK) LLP
Swiss Reinsurance Company Ltd
Sydbank
The Bank of New York Mellon
The Field Effect
The Norinchukin Bank
The Toronto-Dominion Bank
The Wall Street Journal
The World Bank
TMX Group
Tradeweb Europe Limited
Tradition (UK) Limited

UniCredit Bank AG
United Kingdom Debt Management Office
University of the West of England
VÖB-Service GmbH
Westpac Banking Corporation