

ICMA EUROPEAN REPO COUNCIL

DG Internal Market and Services
Financial Services
European Commission
B-1049 Brussels

30 May 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: European Commission Green Paper – Shadow Banking

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 European Commission’s 19 March 2012 Green Paper on Shadow Banking. The ERC notes that on the basis of the outcome of this consultation and the work carried out by the ESRB, EBA, ESMA and EIOPA, the Commission will decide on the appropriate follow-up regarding the shadow banking issues outlined in this Green Paper, including legislative measures, as appropriate.

The repo market is one of the largest and most active sectors in today’s money markets. It provides an efficient source of money market funding for financial intermediaries while providing a secure home for liquid investments. Repo is also used by central banks as their principal tool in open market operations to control short-term interest rates. Repos are attractive as a monetary policy instrument because they carry a low credit risk while serving as a flexible instrument for liquidity management, which benefits the functioning of financial markets. Central banks are also able to act swiftly as lenders of last resort (and have done) during periods of market turbulence by way of the repo market.¹ In a repo transaction securities are exchanged for cash with an agreement to repurchase the securities at a future date. The transaction is collateralised, with the cash securing the seller’s securities and the securities securing the buyer’s cash. Collateral and netting are key to the proper functioning of repo markets. In the event of default, the collateral can be sold and exposure to the defaulting party can be netted off.

¹ The ERC has published a White Paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This paper sets out in greater detail what the repo market is and its benefits and is available via the ICMA website at <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx>.

The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of practitioners in this market, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. A short ICMA ERC position paper “Building and sustaining the European Repo Market”, which briefly examines ICMA ERC’s past and present work, is appended to this response letter.

Commentary:

Whilst there are many elements being considered in the examination of Shadow Banking, the ERC is for now going to primarily restrict its focus to those aspects that bear most directly on repo. Given that the Green Paper specifically identifies “securities lending and repo” as shadow banking activities, even such a limited focus leaves the ERC with many significant points to address.

A. Principal remarks

The ERC notes that the Financial Stability Board (FSB) is engaged in a shadow banking project, which has a workstream securities lending and repos, chaired by the UK FSA’s David Rule. The ERC highlights that on 27 April the FSB published the Interim Report² of this workstream, which has reviewed current market practices through discussions with market participants, and classified the markets into four main, inter-linked segments. This Interim Report goes on to identify those aspects of securities financing markets which the workstream views as constituting potentially important elements of the shadow banking system, as defined by the FSB. In addition, from its review of market practices and regulatory frameworks, the workstream has preliminarily identified seven issues arising from the securities financing markets that might pose risks to financial stability and/or need further investigation by the workstream. These financial stability issues will form the basis for the next stage of the workstream’s work, which is to develop appropriate policy measures to address risks, where necessary, by the end of 2012. The ERC has been actively engaging in support of these FSB efforts, most recently through submission of a comment letter responsive to the Interim Report³, and will continue to do so. The ERC appreciates that the European Commission is represented in the FSB’s work and trusts that the European Commission’s own work will remain informed by and closely aligned with what the FSB is already doing.

Recognising that shadow banking is currently the subject of scrutiny by regulators and that the repo product is part of this process, the ERC identified the need to seek to ensure that policy-makers (a) understand how repo and repo market works and (b) recognise the role repo plays in traditional banking, as well as in supporting the efficiency and stability of the financial system. The ERC therefore commissioned two studies, both written by Richard Comotto of the ICMA Centre. The first of these “Haircuts and initial margins in the repo market”, which was published in February 2012⁴, questions the popular view of the role played by collateral haircuts in the recent crisis. The second “Shadow banking and repo”, which was published in March 2012⁵, refers to the former and elaborates on a number of other key points about the repo market in context of the shadow banking debate. The ERC considers that both of these papers are essential contributions to the current consideration of repos and their role in shadow banking, and accordingly the ERC requests that these two papers be reviewed thoroughly and treated as fully integral elements of this response letter.

² http://www.financialstabilityboard.org/press/pr_120427.pdf

³ http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/ERC-contributions/FSB-interim-SB-report-re-repos_ERC-response_final.pdf

⁴ http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts_and_initial_margins_in_the_repo_market_8_Feb_2012.pdf

⁵ <http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Shadow-banking-and-repo-20-March-2012.pdf>

As already described in the introduction above, the repo market is one of the largest and most active sectors in today's money markets, providing an efficient source of money market funding and an essential tool for use by central banks. In case regulatory measures are adopted which curtail this vital source of funding there will be consequent impacts on economic activity as market users are forced to fall back on other limited sources of funds. One measure which the ERC perceives could act in such a way would be the imposition of mandatory minimum haircuts. The ERC wishes to make quite clear that it is not intrinsically against the use of haircuts. Indeed ERC members routinely utilise haircuts, as required by the application of their respective risk management frameworks. The imposition of mandatory haircuts would, however, be a significantly different matter. Accordingly the ERC respectfully requests that any such step not be taken until there has been full and careful consideration, including open discussions amongst users of repo markets, including central banks, the regulatory authorities and any other appropriate parties.

The ERC considers that it is important to carefully consider both applicable existing regulations and the effect of other regulatory changes which are underway, many of which already bear upon shadow banking in a variety of ways. Hence the ERC welcomes the European Commission's helpful attempt to consider this, as reflected in section 6 of the Green Paper. There are many and complex interactions between the different existing and incoming regulations, adding to the challenge of reasonably assessing the extent to which further regulation may be necessary to address shadow banking concerns. The ERC notes that one important example of new regulations is the leverage limit being introduced as part of the Basel III package of measures. This may prove to have a marked effect upon the procyclicality of the financial system, which could meaningfully alter the extent of incremental concerns about the possible specific contribution of repo to leverage and procyclicality. Hence the ERC considers that, whilst there may indeed be regulatory gaps appropriately needing to be addressed, moves to further directly regulate the repo market need to be subjected to continued open debate and thorough impact assessment.

Additionally the ERC wishes to make clear that the focus of its concerns relate to the fixed income market, which importantly will be the source of the bulk of the collateral for the many purposes for which it will be required. The demands for collateral are developing significantly, in consequence of other major actions which are underway to help rebuild a safe and sound financial system following the turmoil of recent times. Increased collateral use is stipulated through the promotion of central counterparty (CCP) clearing for standardised OTC contracts (EMIR), improved risk management of residual OTC activity (CRD/R) and new bank liquidity buffer requirements (CRD/R). The achievement of these goals will be ill served if constraints on the operation of the repo market impair its ability to efficiently mobilise such fixed income collateral to meet these needs. Notwithstanding the ERC's primary focus on fixed income collateral, which covers a wide range of products – not only government bonds, but also corporate bonds, ABS/MBS and even unsecured bank loans (credit claims), the ERC recognises that there are other important collateral types, including equities, gold and ETFs, which, subject to various degrees of liquidity adjustment, also have potentially valuable roles to play.

B. Detailed remarks

The Green Paper includes 15 specific question, labelled a) – o). In an annex to this response letter we have laid out each of these questions, following the same labelling convention as in the Green Paper, together with the ERC's detailed responses. In a number of instances these responses refer to other relevant materials published by the ERC, which we kindly request that you do consider carefully alongside of this response letter.

Concluding remarks:

The ERC appreciate the valuable contribution made by the European Commission's examination of the issues articulated in this Green Paper and would like to thank the European Commission for its careful consideration of the repo oriented points made in this response. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'De Vidts', with a long horizontal line extending to the right.

Godfried De Vidts

Chairman

ICMA European Repo Council

cc : *David Rule, Financial Services Authority;*
ICMA European Repo Committee

Annex

**ERC Responses: to the specific questions enumerated in the
European Commission's – Green Paper on Shadow Banking**

3. WHAT IS SHADOW BANKING?

Questions:

a) *Do you agree with the proposed definition of shadow banking?*

“Shadow banking” is an imprecise term that has attracted various definitions. We note that the FSB has essentially narrowed this down to “non-banks performing credit intermediation”. In fact, shadow banking is an alternative term for market finance. It is market-based because it decomposes the process of credit intermediation into an articulated sequence or chain of discrete operations typically performed by separate specialist non-bank entities which interact across the wholesale financial market. Shadow banking also relies on active secondary markets in order to be able to price assets and relies on the wholesale financial market for funding. The wholesale financial market includes repo. We stress, however, that repo is also very much a traditional banking tool.

One consequence of the use of the term “shadow banking” seems to be an acceptance that shadow banking is inherently opaque and an assumption by default that traditional banking is more transparent. Fundamentally, we consider that this is wrong. Market-based finance offers opportunities to observe intermediation that do not exist when the process is undertaken within a firm.

The recently published paper “Shadow banking and repo⁶”, as compiled by Richard Comotto, further articulates these points in sections #2 and #11.

b) *Do you agree with the preliminary list of shadow banking entities and activities?*

Should more entities and/or activities be analysed?

If so, which ones?

As in our response to question a), we draw attention to section #2, “What is shadow banking?”, in the above referenced paper “Shadow banking and repo”.

4. WHAT ARE THE RISKS AND BENEFITS RELATED TO SHADOW BANKING?

Questions:

c) *Do you agree that shadow banking can contribute positively to the financial system?*

Are there other beneficial aspects from these activities that should be retained and promoted in the future?

By providing an alternative channel for the flow of funds to the real economy, shadow banking can certainly contribute positively to the liquidity of the financial system. Particularly at a time when the bank financing channel is under pressure, it would be unfortunate if regulation has the effect of unduly constraining the possibility for shadow banking to channel private funds into risk assets. The economy’s need for deep and liquid markets is growing, not shrinking.

Also, while some shadow banking may be the product of regulatory gaps and arbitrage, it is widely recognised that much of this activity is driven by efficiency gains from specialisation and comparative advantage over traditional banks, and is therefore desirable. This point is elaborated on in section #4, “Is there an upside to shadow banking?”, of the aforementioned paper “Shadow banking and repo”.

⁶ <http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Shadow-banking-and-repo-20-March-2012.pdf>

d) *Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*

(i) Deposit-like funding structures may lead to "runs"

We are particularly concerned by the credence that many parties to the shadow banking debate appear to be attributing to the, so called, "Run on Repo", as postulated by Gorton and Metrick⁷. These concerns are mentioned in the aforementioned paper "Shadow banking and repo", but are also the subject of a complete separate research paper by Richard Comotto "Haircuts and initial margins in the repo market"⁸. We believe that this latter paper, which also highlights other supportive research, raises sufficiently compelling doubt to warrant very careful re-examination of the risks posed by repos. Any consequent policy proposals ought only to be formulated in light of such re-examination having been rigorously completed.

(ii) Build-up of high, hidden leverage

The fact that collateral funding may be "churned" several times appears to be articulated in a way which implies this is bad, or at least dangerous. In fact this may not be bad at all and the danger may lie in such churning ceasing to occur. We note that in unsecured funding markets the same finance may similarly pass along chains of intermediaries and be recycled (churned) many times (obviously without any haircut at all). Before the crisis this was the way that much liquidity circulated in the financial markets, including very significant amounts of interbank funding. Markets and regulators have quite correctly realised that reliance on such unsecured funding is unsafe and behaviour has adjusted accordingly. Collateralised funding offers a safer alternative (as routinely practised by central banks), without which there would be a dramatic drying up of liquidity in global financial markets. Hence we consider that there is a need for significant caution before adopting any policy proposals which might lessen the velocity of collateral.

(iii) Circumvention of rules and regulatory arbitrage

We note that there are two distinct dimensions in which these concerns arise. In the first instance the shadow banking debate is inherently focussed on one of these, namely the disparity of rules applied to certain types of entities or activities within a market. This certainly creates a case for broad monitoring of activities across the financial system and highlights the importance of effective supervision of regulated entities and activities. The other dimension is geographic disparity in rules, which is of particular significance given the cross-border nature of global financial markets. This underscores the value in moving to a single rule book within the EU and the importance of the international coordination efforts under the aegis of the G20, the FSB and other international standard setters.

(iv) Disorderly failures affecting the banking system

The financial crisis has prompted both market participants and regulatory authorities to carefully re-appraise risk pricing, with significant changes to perceptions about the appropriate management of both credit and liquidity risk. Whilst there is still some way to go in implementing all of the consequent regulatory changes, which are quite rightly being coordinated through the Basel Committee on Banking Supervision, it appears reasonable to consider that prospectively risk will be more realistically priced. This should already go a long way toward reducing the risks of sudden price discontinuities.

⁷ Gorton, Gary, & Andrew Metrick, Securitised Banking and the Run on Repo, 9 November 2010

⁸ [http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts and initial margins in the repo market_8 Feb 2012.pdf](http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts_and_initial_margins_in_the_repo_market_8_Feb_2012.pdf)

- e) *Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?*

We draw attention to section #3, “Why are regulators concerned about shadow banking?”, of the aforementioned paper “Shadow banking and repo”, which provides a useful recap of ten different points pertinent to the examination of the potential risks presented by shadow banking.

5. WHAT ARE THE CHALLENGES FOR SUPERVISORY AND REGULATORY AUTHORITIES?

Questions:

- f) *Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?*

As already mentioned in response to question d) above, we perceive that there is a case for broad monitoring of activities across the financial system; and also a need for effective supervision of regulated entities and activities. There are a number of ways in which these objectives may be realised, so careful thought should be given to determine the best tools to apply in each particular case. For instance, it may be that market surveys and other aggregate analytic processes are more effective in some instances than the costly compilation of full, granular transaction level details. This might be particularly true for high volume, short term activities such as money markets. Full use should be made of existing data sources, for instance the ICMA European Repo Market Survey⁹. This has been performed twice a year for the past 11 years and clearly helps with the identification of trends in the European repo market.

- g) *Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities?*

Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?

We fully agree that processes should be in place for the collection and exchange of appropriate information. This should leverage the existing mechanisms associated with other regulated financial activities, utilising both national competent authorities and EU level bodies, such as the ESAs and the ESRB; together with the ECB and EU NCBs.

- h) *Do you agree with the general principles for the supervision of shadow banking set out above?*

Subject also to the points made in this response, we agree.

- i) *Do you agree with the general principles for regulatory responses set out above?*

Subject also to the points made in this response, we agree. We consider it likely that the most effective approach will focus on appropriate extension or revision of existing regulation, mindful of a level playing-field between different types of intermediary. New measures directly targeting shadow banking may suffer from static definitions, whilst indirect regulation through links may not sufficiently target shadow banking concerns.

- j) *What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?*

CPSS / ISOCO and the FSB are best placed to ensure consistency of approach. Their mandate should cover not just standard setting but also global supervisory coordination.

⁹ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest/>

6. WHAT REGULATORY MEASURES APPLY TO SHADOW BANKING IN THE EU?

Questions:

- k) *What are your views on the current measures already taken at the EU level to deal with shadow banking issues?*

We applaud the general principle that, before proposing further measures, due account is taken of those pertinent measures which have already been taken. We note that there are inevitably complications which arise from details of each measure which is taken and we will continue to address these appropriately on a measure by measure basis,

Besides considering which measures have already been taken at the EU level to deal with shadow banking issues, a serious effort should be made to review which elements of banking regulation most incentivise shadow banking activities and to consider if useful revisions might be made to lessen such incentivisation.

7. OUTSTANDING ISSUES

Questions:

- l) *Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?*

As also elaborated in our responses to questions n) and k), we consider that it is essential to first think thoroughly and only to act thereafter. Only in this way will the remaining real concerns be correctly revealed, creating the opportunity to identify suitably tailored responses. This will involve the need for much more detailed work. The importance of international consistency adds to the complexity of the task, starting not just with the question of how to define shadow banking but also with the allied task of considering how banking itself is defined. This too is changing in response to existing initiatives, for example the US Volcker rule is realigning trading activity through pushing this out of banks.

Turning to more detailed observations, we will limit ourselves to commenting on some points relating to paragraph 7.3 of the Green Paper, since these matters are most directly those in the ERC's purview. We refer again to the aforementioned paper "Shadow banking and repo" which address detailed points pertaining to a number of the specific issues mentioned in the Green Paper. We particularly note that Richard Comotto address the topics "Does repo amplify pro-cyclicality?" (section #6), "The potential of repo for excessive leverage" (section #7) and "The transparency of repo" (section #9), but also draw attention to his "other" (section #10) and his "general" (section #11) observations.

One specific issue mentioned in paragraph 7.3 of the Green Paper is "re-use of collateral (re-hypothecation)". We wish to stress our concern about the implication that re-use and re-hypothecation are synonymous, when in fact there is a very important difference. Re-hypothecation is a term that applies to pledging. Pledgors are said to hypothecate collateral to pledgees. Typically, the pledgee cannot use the collateral as the pledgor retains legal ownership. Re-hypothecation is a special case where the pledgor gives specific permission for the pledgee to use the collateral and is usually limited to financial assets. Nevertheless, the pledgor retains a security interest in the collateral. In repo (under the GMRA) there is sale, with full title transfer. Since no security interest is retained the security sold in the opening leg of the repo may be freely reused by the purchaser, as is the case with any other asset which he owns. This of course does not negate the fact that the purchaser has any obligation to resell when the date of the closing leg of the repo is reached; and must cover this obligation accordingly.

m) Are there additional issues that should be covered?

If so, which ones?

The importance of collateral has grown over many years, but has accelerated significantly since the advent of the financial crisis in mid-2007. This is in no small measure related to the shift in risk appetite of market participants, with an increased demand amongst them to secure their credit risk exposures through the taking of high quality collateral. Official policy makers have also significantly fuelled collateral demands as they have advanced steps to make markets more robust, to reduce systemic risk and help mitigate the risks of any future financial crises. Amongst examples of these increasing demands are:

- Basel requirements, to be translated in the EU through the CRR/D, introducing the holding of liquidity stress buffers: assets to satisfy these requirements comprise a short list of high-quality collateral;
- the shift of standardised OTC derivatives to CCP clearing, as required in the EU by EMIR, which will give rise to demands for significant amounts of initial margin (as well as some increase in variation margin amounts); and
- increased requirements to margin any bilateral OTC contracts (outside of CCP arrangements), incentivised by penal treatment of uncollateralised exposures in the CRR/D requirements.

It is widely perceived that collateral demands will significantly outstrip supply, so it is essential that collateral be managed as a scarce resource. Given the competing demands that exist for the use of collateral assets, the management of collateral needs to encompass the deployment of optimisation techniques, to ensure that the available collateral is utilised as effectively and efficiently as possible. The industry is already exploring to what extent regulatory pressures may be mitigated through the acceptance of a broader range of collateral assets. For instance, assets such as gold, equities and high-grade corporate debt may have a role to play alongside other already favoured collateral assets – cash, government bonds and covered bonds. Another alternative under active discussion is the utilisation of credit claims (loans) as bilateral market repo collateral, in a similar matter to that already possible when borrowing from central banks. Other potential efficiencies being pursued include:

- harmonisation of requirements, for example so that central banks adopt uniform repo collateral pools; or so that each country accepts the same set of assets for liquidity buffer holdings rather than its own tailored set;
- interoperability amongst market actors to avoid fragmentation of liquidity pools; and
- usage of various forms of collateral swaps, to match collateral sources to uses.

We appreciate, however, each of these possible refinements comes with its own potential drawbacks, and appreciate that public authorities will quite correctly examine the extent to which such refinements may be utilised. What is nevertheless crucial to appreciate is the repo is at the core of collateral provision, since it is the tool through which liquidity is provided to match collateral sources and uses. Thus it is essential that particular attention be paid to any proposals which might impede the ability of repo markets to provide collateral liquidity, as this would inevitably have harmful economic effects given the demand being created for collateral mobilisation.

We note that the development of collateral management tools should be encouraged and that the right regulatory incentives may contribute positively to what is largely an underdeveloped management tool. Various market solutions are being developed but only the major market players can afford such sophisticated products, whereas all market participants would greatly benefit from their wider adoption.

Market participants have developed tools to improve margin call procedures. Accordingly the ERC has recently advanced its best practice guideline to recommend evaluation of required margin calls on the basis of actually settled repo positions. This practise incentivises the use of same day margin call settlement, in order to minimise any lags between settlement of the underlying transactions and the realisation of associated margin call adjustments. As margin calls increasingly become the norm in a wider market context (changes in OTC derivatives are a major development in this context), best market practises as envisaged by the ERC need to be encouraged on a global scale. Furthermore, since repo markets will largely manage the overall use of collateral, endorsement of this “improved” approach should be of significant assistance to market stability, given which the ERC believes that there will be even less possible need for any mandatory haircuts regime.

- n) *What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?*

Before advancing proposals for modifications of the EU regulatory framework it is appropriate to take the time to properly digest the full implications of the directly related work of the FSB, including taking into account related contributions coordinated through IOSCO and the BCBS. Given the complex cross-border and cross-sectoral dynamics of the financial system it is important to take the time to thoroughly analyse the incremental impact of any further regulatory measures. Particularly in case the effect of any such measures was to further impede liquidity, the European economy may suffer unduly. The ERC consider that a global approach to the use of collateral may need to be established through the CPSS, allowing market participants to use collateral in other currency / time zones to raise cross-currency liquidity. This issue was discussed before the events of 2008, but may need to be revived in order to alleviate a potential collateral squeeze.

- o) *What other measures, such as increased monitoring or non-binding measures should be considered?*

Over the years many firms, working individually and in collaboration through a wide range of associations, have made a tremendous and continuous effort to underpin the effective operation of financial markets. Additionally many self-regulatory organisations have provided comprehensive and robust rules and recommendations for market practice; and through the SROCC their initiatives are well known to IOSCO. Notwithstanding the understandable desire to establish a sufficient regulatory framework to provide reasonable assurance as to the robustness of markets, the present and potential future value of these non-regulatory efforts needs to be adequately taken into account. By way of illustration of the breadth of such efforts in the context of the European repo market, we have appended a copy of a short ICMA ERC position paper “Building and sustaining the European Repo Market”. This paper briefly examines ICMA ERC’s past and present work.

Appendix

Background paper outlining the ERC's past and present work

ICMA EUROPEAN REPO COUNCIL

Building and Sustaining the European Repo Market

**A position paper prepared by the
European Repo Council
of the
International Capital Market Association**

April 2012

This paper briefly examines the past and present work of the ICMA's ERC.

Over the years the ERC has contributed to the establishment of a robust infrastructure to underpin the European repo market, including through the development of the Global Master Repurchase Agreement ("GMRA"). These efforts continue unabated, current initiatives including projects to enhance the available of high quality collateral and to boost collateral efficiency. Many current regulatory initiatives are of significance to the repo market and the ERC is actively participating in efforts to ensure that their objectives can be realised, whilst at the same time assuring the continued efficacy of the repo market.

Building and Sustaining the European Repo Market

Given the significant, on-going programme of regulatory reform, within which there is an increasingly crucial role which collateral will play, this is a particularly pertinent time at which to take stock of the work which the European Repo Council (ERC) of the International Capital Market Association (ICMA) has done over the years to contribute to the establishment of a robust infrastructure to underpin the European repo market.

Introduction

Since the early 1990's, ICMA has played a significant role in promoting the interests and activities of the international repo market, and of the product itself. The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of practitioners in this market, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. Membership of the ERC is open to ICMA members who transact repo business in Europe and the twice yearly ICMA ERC General Meetings are widely attended.

The ICMA ERC has become the industry representative body that has fashioned consensus solutions to the emerging, practical issues in a rapidly evolving marketplace, consolidating and codifying best market practice. The discussions that take place at the ERC meetings underpin the strong sense of community and common interest that characterises the professional repo market in Europe.

The ICMA ERC is also responsible for promoting the wider use of repo in Europe, particularly among banks, by providing education and market information. More information may be found on the ICMA ERC's website pages¹⁰.

Documentation

ICMA has been and continues to be an active force in standardising repo documentation. The Global Master Repurchase Agreement (GMRA) is the most widely used standard documentation for the cross-border repo market. It is supported by associated legal opinions obtained by ICMA in more than 60 jurisdictions.

The most recent version of the Agreement, the GMRA 2011¹¹, is the result of a market driven process and wide consultation; it represents over a year's worth of detailed discussion and debate involving market participants and legal specialists.

Besides these formal legal underpinnings for the market, the ERC has promulgated a number of trading guidelines and recommendations¹². These are developed in the overall interest of improving efficiency or liquidity in the market. This is an on-going process, with a new ERC recommendation on Repo matching as a driver for risk reduction having been published in July 2011; and an updated version of the 2005 Best Practice Guide to Repo Margining having been prepared for publication in the second quarter of 2012. Amongst ERC initiatives that are currently underway is a project to codify all these ad hoc documentation elements in a repo code of practice.

¹⁰ <http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/European-Repo-Council/>

¹¹ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/global-master-repurchase-agreement-gmra-2011/>

¹² <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo0/>

Education

Since the inception of its European Seminar in 1974, the ICMA has been committed to providing high quality ICMA Executive Education to its members and to the market at large. Supported by the ERC, this commitment is concretely extended in the repo market context through specialist courses on Securities Lending & Borrowing and on Collateral Management, as well as through targeted seminars providing market participants with the education they need in respect of the GMRA.

Transparency

The repo market is pivotal to other financial markets, particularly those in bonds and derivatives, as it is the main source of financing for dealers. Notwithstanding its importance, it was nevertheless hard to obtain figures on the size of the European repo market. In order to rectify this shortcoming, the ICMA ERC instigated surveys which have become the only authoritative source of data on the size and composition of the European repo market. These surveys are conducted by the ICMA Centre at the University of Reading in the UK.

For the most recent survey a sample of financial institutions in Europe were asked for the value of their repo contracts that were still outstanding at close of business on a single day in December 2011. Replies were received from 64 financial institutions, representing the majority of significant players in the European repo market. The results of this, the twenty-second semi-annual survey of the repo market in Europe set the baseline figure for market size at € 6,2 trillion. The results of all these surveys are publicly available¹³.

Market efficiency

Over the years the ERC has contributed to many initiatives to improve market efficiency, both at its own instigation and in support of the efforts of others. This work stretches across the inter-linked areas of trading, clearing and settlement. Some of the examples of the ERC's own projects are reflected in the trading guidelines and recommendations discussed under documentation (above). Efforts in support of others have included prolonged involvement in market wide expert groups, such as the European Commission's CESAME and the ECB's COGESI.

A significant recent ERC contribution came with the July 2010 publication of published a White Paper¹⁴ on the European repo market, including the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This White Paper emphasises the importance of the repo market for the efficiency and stability of the financial system. It was commissioned by the ERC in response to regulatory considerations which will impact the repo market; and given a perceived urgent need for action to remove the barriers to the efficient cross-border transfer of securities posed by the settlement infrastructure. The White Paper highlights infrastructure problems which have caused fails in the system in difficult market conditions and suggests solutions.

A December 2010 update set out responses to the ERC White Paper and described progress that had been made towards the elimination of barriers to interconnectivity; and a further March 2011 update sets out subsequent responses from the Greek authorities and the Italian CSDs.

¹³ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest/>

¹⁴ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/european-repo-market-white-paper-on-short-selling-and-settlement-failures/>

Collateral initiatives

The importance of collateral has grown over many years, but has accelerated significantly since the advent of the financial crisis in mid-2007. This is in no small measure related to the shift in risk appetite of market participants, with an increased demand amongst them to secure their credit risk exposures through the taking of high quality collateral. Official policy makers have also significantly fuelled the demand for collateral as they have advanced steps to make markets more robust, to reduce systemic risk and help mitigate the risks of any future financial crises.

It is widely perceived that collateral demands will significantly outstrip supply, so it is essential that collateral be managed as a scarce resource. Given the competing demands that exist for the use of collateral assets, the management of collateral needs to encompass the deployment of optimisation techniques – to ensure that the available collateral is utilised as effectively and efficiently as possible.

With a view to improving the efficient utilisation of collateral, by bringing together separate pools of liquidity, the ERC are discussing triparty settlement interoperability between the ICSDs (and eventually CSDs). This effort has been relatively slow to progress but has recently gained greater traction as the focus on collateral intensifies the pressure to ensure that repo can properly perform its role as the provider of assets in the collateral market place. When realised, this project will ensure that liquidity/collateral can flow freely, independent of the location of the collateral.

At the same time the ERC is seeking to increase the supply of high quality collateral assets, by advancing a project to support the use of credit claims as acceptable bilateral repo market collateral. Credit claims, or bank loans, became fully recognised as collateral for transactions with central banks in the Eurosystem in January 2007, following their inclusion in the 'Single List'. In the current climate there is an increasing appetite for the extra financing flexibility that can be realised by extending the use of credit claims, so they can also be mobilised as possible collateral in bilateral repo market transactions.

More broadly, the ERC is supporting the ICMA's 2012 initiative in coordinating the Collateral Initiatives Coordination Forum¹⁵ (CICF). Conceived as a joint trade associations' body, bringing together a broad range of representation from right across the financial industry, the CICF provides a channel for information sharing, education and joint endeavours in the field of collateral. An important measure of the success of the Forum will be ensuring that its work can effectively be channelled into applicable official sector projects, particularly including the collateral harmonisation project recently initiated under the auspices of the ECB's COGESI.

Regulation

Over the years the ERC has contributed to a wide range of regulatory debates, both through its participation in numerous meetings and through written submissions, in respect of consultation papers, regulatory proposals and other similar official papers. Many instances of the ERC's work in this regard are publicly available¹⁶. In performing its work in this area the ERC also seeks to produce papers at its own initiative, in order to better inform deliberations about necessary and appropriate regulatory interventions. The ERC repo market White Paper (see above) is one such example, as is a report on the role of central and commercial bank money in European clearing and settlement¹⁷.

¹⁵ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/collateral-initiatives-coordination-forum/>

¹⁶ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/erc-contributions/>

¹⁷ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/European-repo-market-report/>

Following from the financial crisis which commenced in mid-2007, there is an agreed need to enhance many aspects of financial market regulation. This has spawned a wave of EU regulatory initiatives, impacting all financial market participants, across product areas and through the transaction cycle (trading, clearing and settlement). These are at different stages of their evolution and many of the details remain to be resolved. Nevertheless, there is no doubt that this is a transformational regulatory programme, which includes many elements with significant bearing upon the repo market.

Repos consist of sales and repurchases, typically of high quality fixed income securities.

- The extension of the Markets in Financial Instruments Directive (MiFID) to encompass non-equities markets will bring new trading rules for fixed income. This will require far more trading to be conducted through organised venues and impose calibrated pre- and post-trading transparency requirements.
- Central counterparty (CCP) clearing activities are being regulated through the European Market Infrastructure Regulation (EMIR), with a thrust to maximise the use of CCP cleared, standardised market contracts as opposed to bilaterally cleared, bespoke over-the-counter (OTC) transactions. Whilst most of the focus is on the OTC derivatives market, other OTC markets will also be impacted. In the EU the ERC's repo survey shows that CCP clearing is already used for a meaningful proportion (estimates suggest this may be half of the volume) of repo trades.
- Securities settlement is to be regulated by the Central Securities Depository Regulation (CSDR), which will introduce both an authorisation regime and important market practice requirements. Standard settlement will be set at trade date + 2 days, whilst other measures will enforce market discipline by controlling and penalising the treatment of fails.
- Certain specific trading activities are also being directly regulated, as for example with certain short selling activities captured by the Short Selling Regulation (SSR).

Increased demand for collateral is also being driven by regulatory reforms, examples including:

- Basel requirements, to be translated in the EU through the Capital Requirements Regulation/Directive (CRR/D); introducing the holding of liquidity stress buffers – assets to satisfy these requirements comprise a short list of high-quality collateral;
- the shift of standardised OTC derivatives to CCP clearing, as required in the EU by EMIR, which will give rise to demands for significant amounts of initial margin (as well as some increase in variation margin amounts); and
- increased requirements to margin any bilateral OTC contracts (outside of CCP arrangements), incentivised by penal treatment of uncollateralised exposures in the CRR/D requirements.

For the ERC one other very significant element of the regulatory programme is the initiative to ensure the correct regulatory treatment of “shadow banking”. The ERC has been closely engaging with the Financial Stability Board's (FSB's) applicable shadow banking workstream, led by the UK FSA's David Rule. The Interim Report of this workstream describes the securities lending and repo markets in overview; key drivers of these markets; their location within the shadow banking system; the existing regulatory framework in overview; and financial stability issues. The workstream is due to present its proposals for regulatory measures by the end of 2012. In parallel, the EU has its own shadow banking proposals under development by the European Commission. In context of this shadow banking debate, the ERC wishes to ensure that policy-makers understand how repo and repo markets works, and that they recognise the role repo plays in traditional banking, as well as in supporting the efficiency and stability of the financial system. It therefore commissioned two studies¹⁸, the first on collateral haircuts, the latest on issues such as asset encumbrance and transparency.

¹⁸ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/shadow-banking-and-repo/>

Summary of the ERC's position

For many years the ICMA ERC has contributed to the establishment and maintenance of a robust infrastructure to underpin the European repo market. It will continue to do so.

Underpinning this is the GMRA, which is the most widely used standard documentation for the cross-border repo market. It is supported by associated legal opinions obtained by ICMA in more than 60 jurisdictions.

Complementing this sound legal basis for repo activity, the ERC has promulgated a number of trading guidelines and recommendations developed in the overall interest of improving efficiency or liquidity in the market. This is an on-going process.

The ERC actively promotes high quality education, through its provision of specialist courses and targeted seminars.

To promote transparency the ERC instigated and maintains a twice yearly survey, which has become the only authoritative source of data on the size and composition of the European repo market.

The ERC actively promotes the enhanced efficiency of the European repo market, at its own initiative and in collaboration with other projects, including those led by the public sector.

The ERC White Paper produced in July 2010 and subsequently updated, provides a benchmark description of the European repo market and highlights specific needs for reform of the market infrastructure. Continued progress to close these gaps is an essential precursor for the establishment of an efficient EU single financial market.

Collateral demands will significantly outstrip supply, so it is essential that collateral be managed as a scarce resource. It is essential that the repo market is not hindered from fulfilling its role as the provider of assets in the collateral market place.

The ERC supports increased efficiency in the utilisation of collateral through the removal of barriers to the free flow of liquidity. The ERC project to establish triparty settlement interoperability between the ICSDs is an important example of this commitment.

The ERC supports the increased availability of high quality collateral assets. The ERC project to establish the safe utilisation of credit claims as collateral for bilateral repos is an important example of this commitment.

The ERC supports the establishment of a robust financial regulatory framework within which the repo market can operate safely and efficiently. As new regulations are being simultaneously established for trading, clearing and settlement, there is a greater need than ever to engage in close, open dialogue so that official objectives can be realised, whilst at the same time assuring the continued efficacy of the repo market.

The ERC has a vital role to play in relation to collateral initiatives. It actively contributes to these both within the private sector (e.g. via CICF) and in partnership with the official sector (e.g. via COGESI).

Any direct regulation of repo, as considered in context of work on shadow banking, must be based on a thorough examination of the way in which repo and the repo market works. The ERC proactively seeks to ensure the necessary information is available to make this possible.