

ICMA EUROPEAN REPO COUNCIL

European Securities and Markets Authority (ESMA)
103, Rue de Grenelle
75007 Paris
France

2 April 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: Joint Discussion Paper “Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories” (JC/DP/2012/1)

Introduction:

The purpose of this letter is to provide feedback on behalf of the International Capital Market Association’s (“ICMA’s”) European Repo Council (“ERC”), concerning the repo oriented aspects of the Joint Discussion Paper “Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories” (JC/DP/2012/1), as published on 6 March.

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.

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 during periods of market turbulence by way of the repo market.¹

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>.

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.

In the international market, the Global Master Repurchase Agreement (GMRA)² provides a robust legal framework for documenting repo transactions. Supervisory authorities recognise the effect of the GMRA netting provisions for regulatory capital and large exposure requirements provided, inter alia, that a reasoned legal opinion has been obtained to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would find that, where a counterparty fails owing to default, bankruptcy, liquidation or any other similar circumstance, the regulated firm's claims and obligations pursuant to the GMRA would be limited to a net sum under the law of the relevant jurisdiction(s), and meets certain other requirements. Against this background, ICMA obtains and annually updates legal opinions on the GMRA, currently from 62 jurisdictions worldwide, for the benefit of its members. These opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole.

Commentary:

The ERC notes that this discussion paper seeks stakeholders' views on the regulatory technical standards (RTSs) which the European Supervisory Authorities (ESAs) are required to jointly develop, specifying the requirements on risk mitigation techniques for OTC derivative contracts not cleared by a CCP.

The ERC also notes that whilst the RTSs considered by this discussion paper are specifically concerned with OTC derivatives, they are nevertheless a part of the European Market Infrastructure Regulation (EMIR) which is itself a framework with broader ramifications. Accordingly the ERC considers that, as the ESAs advance their essential work to elaborate the technical details necessary to operationalise the EMIR legislative framework, it is vital to establish standards which, whilst being robust, retain adequate flexibility to allow calibration suited to the efficient operation of markets in, and specific characteristics of, different, non-derivative, asset classes.

In context of this overall concern, the ERC has the following brief observations in relation to a few of the matters considered in the discussion paper.

Q14: As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

In relation to the ESA's consideration of such matters of margin best practice, the ERC draws attention to the fact that on 15 September 2005 the ERC published a [Best Practice Guide to Repo Margining](#).

Consistent with its on-going commitment to promote best market practices, the ERC has recently been reviewing this document and has identified some scope to make improvements. In particular changes are now recommended to:

² The GMRA is the most extensively used cross border repo master agreement and has reduced the risks associated with previously poorly documented repo transactions.

- Provide that margin be based on actual rather than assumed settlement;
- Ensure mutual agreement of margin calculation methods, since GMRA 2011 now embraces two alternatives;
- Provide guidelines on minimum transfer amounts and interest;
- Avoid netting of consecutive day's margin movements; and
- Encourage migration towards same day settlement of margin calls.

Accordingly revised guidance is being prepared and will shortly be published, alongside a recommendation for adoption as from 1 July 2012. The ERC believes that these incremental changes will significantly assist in embedding the most up to date margin risk management practices across the repo market.

Paragraph 41

“When setting the minimum level of IM requirements and the parameters that need to be considered for the calculation of IM, due respect should be given to macroprudential considerations and possible procyclical effects that these could play.”

The ERC draws ESMA's attention to the paper "[Haircuts and initial margins in the repo market](#)", written by Richard Comotto of the ICMA Centre and published by ICMA on 8 February. Whilst this paper does not focus on the setting of OTC derivative margins, it quite clearly highlights that careful analysis is needed to support any conclusions regarding the extent to which margins play a significant part in procyclicality. Any measures to take into account the procyclicality of haircuts, as contemplated in paragraph 41 of the ESA's discussion paper, ought only to be determined on the basis of a clear understanding of the actual extent of any relationship and will need to be sensitive to differences across asset classes.

Q33: Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so, which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?

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. At the same time 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.

Amongst examples of these increasing demands are:

- increased focus on covered bond issuance by banks, secured against high-quality mortgage pools, as against senior unsecured issuance;
- increased use of repo funding to finance assets, including in context of an increase in the use of central bank financing;
- 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.

Whilst these examples are couched in their European context, equivalent pressures also exist across global markets.

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 ERC considers that the design of collateral requirements should be taken forward in a way which allows for flexible consideration of the broadest possible range of collateral assets. Naturally the leading consideration must be safety but it may well be that appropriate risk management procedures can be established to make possible the safe utilisation of many forms of collateral asset. No doubt this would to some extent be predicated upon the instigation of a suitably risk sensitive haircuts regime.

Q39: Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?

Please see the point made above in relation to "Paragraph 41", which is also pertinent here.

Concluding remarks:

The ERC draws attention to the fact that, through ICMA, it is contributing to the development and work of the Collateral Initiatives Coordination Forum (CICF), a joint trade associations' body established at the beginning of 2012. Bringing together a broad range of representation from right across the financial industry, the CICF provides a new and helpful channel for information sharing, education and joint industry endeavours in the field of collateral.

The ERC appreciate the valuable contribution made by the ESA's examination of the issues articulated in this discussion paper and would like to thank the ESAs for their careful consideration of the repo oriented points made in this response. Whilst only a short period was available for formal review of this discussion paper, the ERC will continue to elaborate its thinking in respect of the questions under consideration and 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 flourish extending to the right.

Godfried De Vidts

Chairman

ICMA European Repo Council

cc : *ICMA European Repo Committee*