ICMA
International Capital Market Association

EUROPEAN REPO COUNCIL

Investment Banking Resolution
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

05 March 2010

Dear Sirs,

Response submission from the European Repo Council
Re: HM Treasury Consultation – "Establishing resolution arrangements for investment banks"

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 concerning the repo specific aspects of HM Treasury's 16 December 2009 consultation paper – "Establishing resolution arrangements for investment banks".

The ERC was established by ICMA in December 1999, to represent the repo community in Europe. It is composed of practitioners in the repo field, 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 and, as evidenced in the recent market turmoil, plays a critical role in liquidity provision for the financial system. 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. In repo transactions securities are exchanged for cash with an agreement to repurchase the securities at a future date. The securities serve as collateral for what is effectively a cash loan and, conversely, the cash serves as collateral for a securities loan. Collateral is key to the proper functioning of repo markets. In what is truly an international market, the world's unique global documentation for repo transactions is the GMRA (the most prevalent version being GMRA 2000[1]).

[1] The Global Master Repurchase Agreement (GMRA) 2000 is the most extensively used cross border repo master agreement and has reduced the risks associated with previously poorly documented repo transactions.

Scope of Review:

Whilst there are many interesting issues discussed in this HM Treasury consultation paper, the ERC is going to restrict its focus to those aspects that bear directly on repo.

The pertinent sections of the consultation paper are:

7.3 Based on discussions with the Advisory Panel, the Government believes that the extent of value destroyed for unsecured creditors during the insolvency of an investment firm is broadly commensurate with that involved in the failure of other types of firms. However, there are some discrete factors that may need to be addressed, which may otherwise cause the insolvent estate, and therefore its unsecured creditors, to face significant losses. These include:

- uncertainty around the timing of counterparty terminations and close out valuations in derivatives agreements. The Government is of the view that the market should move towards incorporating a defined period for termination within these contracts. It will monitor developments closely and may consider applying bar dates for termination of derivatives contracts, should it be considered necessary.
- difficulties faced by administrators in managing trading book risk exposures of a failed investment firm. The Government proposes to provide administrators with a range of options to engage risk managers and focus on risk management under administration, through a resource centre as outlined below.
- challenges around managing repo-market close-outs effectively.

Repo-market close-outs

7.24 During the financial crisis, large banks and investment firms found it difficult to depend on repo financing to meet their obligations due to increasing repo rates and "haircuts" in the repo markets and the refusal by lenders to accept some kinds of securities as collateral. Repo counterparties required higher haircuts or margins from firms facing liquidity problems to account for uncertainty related to the value of collateral.

7.25 In terms of the value recovered for general creditors of an investment firm, there may be a case for policy action to deal with value trapped with clearing banks or repo counterparties if they hold on to 'excess' collateral from a defaulting investment firm.

7.26 Repo collateral is held by either a tri-party clearing bank, or directly by the lending counterparty if there is no third-party clearing. If the borrowing investment firm is unable to repay the cash to the clearing bank or cash lender, then the counterparty would need to sell the collateral to recover its cash. The repo counterparty would then need to return any cash over and above what was owed to it by the investment firm (i.e. 'excess' collateral or cash) back to the defaulting investment firm.

7.27 However, if the counterparty finds it difficult to sell the collateral or there is significant disagreement between the counterparty and administrators on close-out values, it may result in the counterparty holding on to the excess collateral if any, which means that the insolvent investment firm's estate could be losing value. The value of repo market collateral can potentially be significant in the case of investment firms and the excess held with the repo counterparty has the potential to affect the returns to unsecured creditors substantially. The Government is considering the extent to which this issue needs to be addressed, and what possible steps may need to be taken.

Question 82

Do you have views on the difficulties that repo market transactions could pose for the insolvency of an investment firm, affecting value recovered for creditors? If this is a concern, what kind of policy action could the Government consider to address it?

ERC Feedback:

The ERC has carefully deliberated the content of these particular paragraphs, together with the associated question 82, and is pleased to put forward its considered response.

Whilst the ERC recognizes the validity of the comments in paragraph 7.24, it is important to appreciate that the evolution of market terms is a natural function of changed market conditions. Thus the changes in terms resulted from, rather than led to, the downturn of conditions outside the repo market. Also, notwithstanding that some firms may then have found it harder to depend on repo funding, it is the case that the beneficial structure of collateralised lending, inherent in repo financing, became even more significant. Overall repo funding in fact became more important as a source of funding, as providers of unsecured funding withdrew from risk taking.

The Bank of England, in common with many other central banks, utilises repo transactions to guide monetary policy implementation. As a part of the terms and conditions of these facilities provisions are put in place that allow the receiver of collateral to request protection against adverse changes in the value of the underlying, a technique used by market participants and central banks alike. This built-in mechanism allows the cash lender to proactively protect the value of the cash. In the turmoil this technique of additional margin calls was used by many participants to protect against the decrease of value of the received collateral (securities) and in extreme circumstances can lead to haircuts up to 100% (i.e. making the use of the collateral in question uneconomical for the cash borrower). This extreme rejection of collateral can be most effectively managed where the terms and conditions of the bilateral agreement, under which it has been advanced, contemplate the possibility of alternative actions (such as its withdrawal and replacement). This has the benefit for the cash lender that he is able to receive new collateral allowing the outstanding trades to be honored. It has also a benefit for the cash taker, who can try to find other sources of funding for the collateral rejected by the initial counterparty. It would be imprudent for the collateral to remain on the books of the cash lender with a haircut of 100%. In case of a default the residual value of these bonds would normally retain some market value and as such put the liquidator of the collateral (i.e. the cash lender) in an abnormally comfortable position. In any case, without the above described technique repo transactions would simply become similar in profile to the use of unsecured cash – with the consequent significant capital requirements provided for by the Basle 2 regime.

The repo product has accordingly been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of the sort of market consistent documentation that the European Financial Markets Lawyers Group[2] now seeks to further promote.

[2] http://www.efmlg.org/home.htm

For instance, in relation to repo transactions governed by the GMRA 2000, where a party to the GMRA has a net exposure in respect of the other party it may by notice to the other party require the other party to make a margin transfer to it (any, or a combination of, cash or securities) equal to that exposure. In the scenario envisaged above, where the value of the received collateral has decreased to a point where it has become uneconomical to use for the cash borrower, parties to the GMRA may agree not to apply the margin maintenance provisions of the GMRA but to reprice transactions (GMRA 2000, para 4(j)) or to eliminate an exposure by adjusting transactions (GMRA 2000, para 4(k)). The adjustment method terminates the original transaction and the parties enter into a replacement transaction with new securities provided as collateral, whose value is substantially equal to the repurchase price under the original transaction.

Paragraphs 7.25 – 7.27 address the question of collateral and the concern that excess collateral may be trapped in the hands of repo creditors to the detriment of unsecured creditors. The ERC underscore that the purpose of taking collateral is one of prudent risk management. In so doing experienced judgments are made regarding how much collateral, of what type, needs to be held at any point in time. This will be reflective of the credit exposure faced and the applicable market conditions. Market practices in this regard reflect the recommendations for a "Best Practice Guide to Repo Margining", as issued by the European Repo Committee (the ERC's governing board) in 2005[3]. It is important to note that in case there is a default scenario, it will only be once the whole portfolio is sold off that a determination can be made as to whether or not there is in fact any over-collateralisation. Accordingly it is only at this point that it becomes possible to return an excess for the benefit of unsecured creditors – to release any collateral sooner would be imprudent.

In the context of the GMRA 2000, the occurrence of an event of default has the effect of accelerating outstanding transactions and turning delivery obligations in respect of securities to cash sums based on default market value, then applying set off. A net sum will become due in favour of the party with the higher valuation for its transactions. The acceleration and conversion of obligations serves to reduce the risk of negative price movements in purchased securities following a default. The default market value is calculated by the non defaulting party in accordance with established principles which consider actual sale or purchase prices, market value quotations or fair market value as determined by the non defaulting party acting in good faith (GMRA 2000 para 10(e)). As this legal provision makes clear, it is important to recognize that as part of the unwinding process, firms are required to act in good faith and therefore they cannot sell assets at fire-sale prices – rather they will discharge the sale of collateral in a responsible manner. This aspect is the crucial one, as it is in this way that any excess value, that transpires to have been held by repo creditors, is protected for the benefit of unsecured creditors.

The ERC would also highlight that the effect of the HM Treasury proposal would be to transfer risk from the unsecured market to the secured market which would not create the right incentives, particularly as several other officially sponsored steps being taken in response to the crisis emphasise that responsible market participants should seek to adequately collateralise their credit exposures. The ERC firmly believe that, as a matter of well established legal principle, value should not go to unsecured creditors over the interests of secured creditors.

[3] https://www.icmagroup.org/ICMAGroup/files/75/7525d290-bff4-4054-8ec8-bfc351ac053b.pdf

There is however an important need to consider the risks faced by unsecured creditors and, where there is a mixture of secured and unsecured financing, an important tool in this regard is an encumbrance ratio. One possibility could be to require the publishing of encumbrance ratios, which would give more transparency to unsecured creditors; and it is possible to contemplate that limits should be created regarding how high a ratio is permissible (perhaps differentiated by the borrower's type). Such concepts are of course already found in many privately negotiated unsecured financing contracts. Of course this is just one element of credit risk management, in the context of which all banks have unsecured lending limits to counterparties (both other banks and corporates). These limits are part of an overall risk profile vis a vis counterparties that will include lines for all product exposures with those clients.

The ERC believes that the interests of all parties are best served if provisions applicable to repos are as efficient and effective as possible. Limiting repo creditors' security rights imposes more risk, increasing financing costs and thereby harming the economic position of end-users, be they market participants or central banks conducting their monetary policy operations. Moreover, the financial crisis highlighted the global scale of markets and their interconnectivity. The collateral analysis provided in the latest ICMA European repo market survey (conducted in June 2009[4]) shows that collateral is not limited to European countries. Over 20% of collateral is from outside the European Union, evidencing that ERC members trade with counterparties on a global scale. Therefore any steps to be taken need to be considered and consistent at an international level. Nothing should be done that could lead to an undermining of confidence in the current legally robust framework for repos, since that could actually precipitate a worse crisis in the daily management of liquidity.

The ERC appreciate the valuable contribution made by HM Treasury's examination of the issues articulated in this consultation paper and would like to thank HM Treasury for its careful consideration of the repo specific points made in this response. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,

Godfried De Vidts
Chairman
European Repo Council

CC : ICMA European Repo Committee

[4] https://www.icmagroup.org/ICMAGroup/files/3f/3fb33acf-f14c-4469-a3dc-c101c9c74f59.pdf