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Press release

News from the International Capital Market Association (ICMA)

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ICMA European Repo Council paper explores official concerns about 'shadow banking' and repo

(Zurich, Switzerland) ICMA's European Repo Council (ERC) has today published a paper entitled: 'Shadow banking and repo' which explores concerns raised by regulators about 'shadow banking', particularly in the context of the European repo market. The paper, written by Richard Comotto of the ICMA Centre, is intended to inform the 'securities lending and repo' workstream set up by the Financial Stability Board within its shadow banking project and the European Commission's own deliberations discussed in yesterday's green paper.

Godfried De Vidts, Chair of ICMA's European Repo Council said: "Comotto's paper frames a number of technical issues in a way which allows properly informed consideration of regulatory concerns. We should not lose sight of the fact that repo is a legitimate funding tool used by regulated banks and financial institutions and an instrument of financial policy for central banks. On the transparency issue the ICMA ERC already collects data on the size and structure of the market though its long established survey. A new survey of haircuts in the European repo market will add to the understanding of the functioning of repo in difficult market conditions."

The Comotto paper makes a number of key points about the repo market in Europe:

- Repo is not inherently a 'shadow banking' tool. It has been widely used by traditional banks in Europe for many years and has helped many of these to ride out the crisis by giving them continued access to a source of term funding when unsecured term markets have been closed to them. Regulatory change needs to be careful not to undermine the efficiency of this important funding market or it risks restricting the flow of funding ultimately into the real economy.

- Regulators are concerned that collateralised instruments like repo facilitate or even encourage excessive leverage, which was a major factor in the recent crisis. In practice however, markets will not allow banks to keep borrowing, even against good collateral. The role of collateral is often misunderstood. Lenders are not indifferent to counterparty risk because of collateral. The repo market tends not to lend to riskier counterparties, even if they can offer the best collateral.

- A further concern of regulators has been the risk that collateralised lending 'encumbers' assets, in other words, there is less for distribution to unsecured creditors if a borrower goes bust. The paper argues that the risk of encumbrance is largely illusory, because assets given as collateral are replaced by cash.

- Use of collateral does not make borrowing risk-free but its prudent use is a source of stability for individual institutions and markets. There is a danger that the current discussion about collateralised lending paints collateral in a negative light. But collateralised lending is always preferable to unsecured funding. Regulators should therefore avoid action on repo that distorts the relative pricing advantage of secured over unsecured funding.

- Some commentators have suggested that repo suffered from a lack of transparency in the way it is accounted for on a bank's balance sheet. In fact, the standard method of accounting expands the balance sheet to signal leverage, recent high profile cases involving misrepresentation of repo activity, for example Lehman, have been down to firms exploiting accounting loopholes.

- There is a case for improving the transparency of the repo market, although a lot of data already exists (including the ICMA's semi-annual survey of the European repo market) and much is underexploited. Suggestions of a repo trade repository need to be carefully assessed. Trade repositories in instruments like derivatives have been proposed in order to address operational complexity, not just to collect market data.

A copy of the paper is available at www.icmagroup.org

Notes for editors

1. ICMA European Repo Council (ERC)
The ERC was established in December 1999 by ICMA. Membership is open to any ICMA member who undertakes dedicated repo markets activity. The ERC seeks to address market practice issues arising in the cross-border repo market in Europe. A core responsibility of the ERC and one of the original reasons for its existence is to assist ICMA in maintaining the legal documentation which underpins the safe functioning of the cross-border repo market, specifically, the Global Master Repurchase Agreement (GMRA).

2. International Capital Market Association (ICMA)
ICMA represents financial institutions active in the international capital market worldwide. ICMA's members are located in 50 countries. ICMA's market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments. See: www.icmagroup.org

3. ICMA Communications

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