

ICMA EUROPEAN REPO COUNCIL

Financial Stability – Contingency Planning Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

24 September 2012

Dear Sirs,

Response submission from the European Repo Council

Re: HM Treasury Consultation – “Financial sector resolution: broadening the regime”

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 1 August 2012 consultation paper – “Financial sector resolution: broadening the regime” .

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, together with two subsequent published update papers, via the ICMA website at <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx>.

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”)². These efforts continue unabated, current initiatives including projects to enhance the availability 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 applicable regulatory objectives can be realised, whilst at the same time ensuring the continued efficacy of the repo market.

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 few technical aspects which bear most directly on repo.

From this limited perspective the ERC considers that the most pertinent section of the consultation paper is #2.24 which mentions the concept of “... a short stay on the exercise of early termination and close-out netting rights in financial contracts held by counterparties of a failed firm.”, as proposed in the draft Recovery and Resolution Directive published by the European Commission. This concept is then revisited in paragraph #4.7 which mentions “... additional powers such as stays on early termination rights and moratoria on payments to creditors...”; and in paragraph #42 of the impact assessment “• A moratorium preventing outgoing payments from a FMI and a stay on creditor actions to attach assets or otherwise collect money or property from the entity which is under resolution;”.

Table 1.A of the impact assessment goes on to indicate that in relation to “Temporary stay on rights to early termination of financial contracts” HM Treasury’s planned approach is to do nothing, as this is an expected European led process. Similarly Table 1.B of the impact assessment indicates that in relation to “Moratorium preventing outgoing payments from a CCP” the planned approach is again to do nothing, for the same reason.

ERC Feedback:

The ERC notes that this consultation paper does not elaborate any details in relation to these points concerning stays of payment rights and payments moratoria; and that the proposed approach is simply to follow applicable EU developments. The ERC acknowledges the validity of this approach, but nevertheless wishes to take the opportunity to highlight its more detailed concerns in relation to these types of provisions. Accordingly the ERC respectfully draws attention to its September 2012 response to the joint CPSS and IOSCO public consultative report “[Recovery and resolution of financial market infrastructures](#)”; and to its March 2010 response to HM Treasury’s earlier consultation paper on “[Establishing resolution arrangements for investment banks](#)” (copies of both of which are appended hereto for ease of reference). The ERC requests that the details elaborated in these responses be borne in mind as the current process progresses to more detailed subsequent steps.

In summary you will see from these more detailed response letters that the ERC believes that 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. In particular, limiting repo creditors’ security rights, for example through the imposition of temporary stays, imposes more risk, thus increasing financing costs and thereby harming the economic position of end-users, be they market participants or central banks conducting their monetary policy operations. Accordingly the imposition of any such feature should be strictly limited.

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.

Conclusion:

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,

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

Godfried De Vidts

Chairman

ICMA European Repo Council

cc : ICMA European Repo Committee

APPENDICES

Reference copies of the ICMA ERC's response submissions of:

- A. 24 September 2012, regarding the joint CPSS and IOSCO public consultative report "Recovery and resolution of financial market infrastructures"; and
- B. 5 March 2010, regarding HM Treasury's earlier consultation paper on "Establishing resolution arrangements for investment banks".

ICMA EUROPEAN REPO COUNCIL

CPSS Secretariat
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

IOSCO Secretariat
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

24 September 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: Joint CPSS and IOSCO Public Consultative Report - "Recovery and resolution of financial market infrastructures"

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 certain repo oriented aspects of the joint Committee on Payment and Settlement Systems ("CPSS") and Board of the International Organization of Securities Commissions ("IOSCO") public consultative report "Recovery and resolution of financial market infrastructures", as published on 31 July.

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, together with two subsequent published update papers, via the ICMA website at <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx>.

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”)². These efforts continue unabated, current initiatives including projects to enhance the availability 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 applicable regulatory objectives can be realised, whilst at the same time ensuring the continued efficacy of the repo market.

Commentary:

The ERC notes that this joint consultative paper considers a wide range of potential measures intended to ensure that authorities across the globe have the powers and tools necessary to achieve effective resolution of systemically important financial market infrastructures (“FMIs”). Whilst many of these important proposals are of significant interest, this response nevertheless just focuses on those specific elements of the proposals which are of particular interest from the repo market perspective. These elements are “moratorium preventing outgoing payments from an FMI (Key Attribute 3.2 (xi))”, as described on page 11 of the joint CPSS and IOSCO public consultation report; “Setoff, netting, collateralisation, segregation of client assets (Key Attribute 4)”, as described on page 13; and “Stays on early termination rights based upon entry into resolution (Key Attributes 4.3 and 4.4)”, as described on page 14.

The ERC also notes that on 19 July 2011 the Financial Stability Board (“FSB”) issued a consultative document³ – “Effective Resolution of Systemically Important Financial Institutions”, which led to the FSB’s final report⁴ “Key Attributes of Effective Resolution Regimes for Financial Institutions”. The current CPSS and IOSCO consultative report seeks to apply these FSB Key Attributes in a manner appropriate for FMIs and consequently covers many similar points to those raised in the FSB’s July 2011 public consultation. Under date of 18 August 2011 the ERC responded to this earlier FSB consultation on the specific topic of its bail-in proposals. Given the degree of overlap between these two consultations, we respectfully request that you carefully review and fully consider this earlier ICMA response letter (a copy of which is attached for ease of reference) in the context of the current joint CPSS and IOSCO public consultation process.

Consistent with this overall outline approach, the ERC has the following brief observations:

Introductory observation regarding the use of CCPs

The introduction to the joint consultative paper notes the G20 commitment that all standardised over-the-counter (OTC) derivatives should be cleared through CCPs (paragraphs 1.2 and 1.3). Recent developments in the repo market serve to illustrate that, notwithstanding the attractions of CCP clearing, the adoption of too aggressive an attitude to risk may very well serve to drive trades out of the CCP. The example seen in the repo market involves certain parts of the user community being allocated substantially higher haircuts/initial margin, often due to wrong way risk. This leaves these institutions having no choice other than to look for counterparties willing to trade bilaterally. Particularly in fixed income repo markets where collateral equates to cash – and where there is a squeeze on available collateral for different market requirements – this can prove counterproductive.

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.

³ http://www.financialstabilityboard.org/publications/r_110719.pdf

⁴ http://www.financialstabilityboard.org/publications/r_111104cc.pdf

FMI's that take on credit risk

The joint consultative paper notes that certain types of FMI take on credit risk as part of their services (paragraph 3.8) and that these FMIs are particularly exposed to risks from default by their participants, and perhaps also to losses on investments that the FMI holds on its own balance sheet as part of providing its services and for the return of which it is liable to participants (for example, investment of cash margin).

The ERC observes that the risk of loss on investment of cash margin should be mitigated by a requirement that any such investment be made on a secured basis. The ERC highlights that in such situations there should not then also be a restriction on the receiving party's re-use of the invested assets. Any such restriction of re-use would be duplicative of the safety achieved through the use of a secured investment strategy and would have a directly detrimental impact on future liquidity distribution in the system.

Moratorium preventing outgoing payments from an FMI (Key Attribute 3.2 (xi))

The ERC strongly supports the analysis of this point as described in paragraph 4.7 of the joint consultative report. Indeed, the "ability to continue to make payments is a fundamental part of the service" provided by FMIs; and a "resolution authority's decision to impose a moratorium to prevent outgoing payments by the FMI even for a short period is therefore likely to carry the risk of continuing or even amplifying systemic disruption." Accordingly the ERC concurs with the conclusion that "a moratorium on payments in a CCP, a payment system or an SSS would mean a full or partial stoppage of the system, probably defeating the objective of continuity of critical operations and services", as stated in paragraph 4.8 of the joint consultative report.

Setoff, netting, collateralisation, segregation of client assets (Key Attribute 4)

The ERC fully supports that the "Key Attributes require that the legal framework governing setoff rights, contractual netting and collateralisation agreements, and the segregation of client assets should be clear, transparent, understandable and enforceable"; and that "an FMI's legal basis should provide a high degree of certainty for each material aspect of an FMI's activities in all relevant jurisdictions", both as stated in paragraph 4.15 of the joint consultative report.

The importance of these points resonates with the ERC since, as already noted in the introduction to this response, collateral and netting are key to the proper functioning of repo markets. In the international market, the GMRA 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 opinions⁵ on the GMRA, currently from over 60 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.

⁵ <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/GMRA-Legal-opinions>
(for further details, please contact the ICMA Legal helpdesk: +44 20 7213 0330 / legalhelpdesk@icmagroup.org)

Stays on early termination rights based upon entry into resolution (Key Attributes 4.3 and 4.4)

Paragraph 4.16 of the joint consultative report states that “Another power available to resolution authorities is the power to stay temporarily the exercise of early termination rights that may otherwise be triggered upon entry of a firm into resolution or otherwise in connection with the use of resolution powers.” As previously stated in its 2011 response (referenced above) to the FSB, “Any suspension of close out netting rights alters the measure of risk to which a party is exposed. In a repo context, this would result in a requirement for increased collateral to account for market movement during/post the period of suspension and thus has clear consequences on the cost and therefore the attractiveness of this essential form of short financing. Furthermore costs may also arise in case new measures adversely impact the efficacy or enforceability of netting, with consequent impacts on regulatory requirements and/or legal certainty. For these reasons the ERC regards the imposition of a temporary suspension of close out netting as undesirable. If there is, nevertheless, to be any form of suspension of rights it is essential that this should be both clearly defined and as limited as possible in terms of time frame.” The ERC’s views on these matters are further elaborated in its earlier response.

Consistent with its previously documented views, the ERC is pleased to note that paragraph 4.18 of the joint consultative report states that “The Key Attributes require, however, that this stay be strictly limited in time”; and that this paragraph also generally clarifies that any close out rights arising by reason of other termination triggers should not be impeded.

Concluding remarks:

The ERC appreciates the valuable contribution made by the CPSS and IOSCO through their joint examination of the issues articulated in this public consultative paper and would like to thank them for their careful consideration of the points made in this response. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,



Godfried De Vidts

Chairman

ICMA European Repo Council

cc : ICMA European Repo Committee

ATTACHMENT

Reference copy of the ICMA ERC's 18 August 2011 response submission regarding the FSB's Consultation Paper "Effective Resolution of Systemically Important Financial Institutions"

ICMA EUROPEAN REPO COUNCIL

Financial Stability Board
Centralbahnplatz 2
CH-4002 Basel
Switzerland

18 August 2011

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: FSB Consultation Paper – “Effective Resolution of Systemically Important Financial Institutions”

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 FSB Consultation Paper “Effective Resolution of Systemically Important Financial Institutions”, published on 19 July.

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 or Agreement)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.

The ERC notes that on 20 October 2010, the European Commission announced its plans for an EU framework for crisis management in the financial sector. Further to this, DG Internal Market and Services then consulted on the technical details of such a framework in order to inform the preparation of a formal Commission legislative proposal scheduled for adoption in 2011.

Commentary:

Whilst there are many interesting issues discussed in this consultation paper, the ERC is going to restrict its focus to those aspects that bear most directly on repo. As the ERC sees it, the particularly pertinent matters are those relating to the temporary suspension of rights – as described on pages 21 – 22 of the consultation paper and in its Annex 8 “Discussion note on conditions for a temporary stay on early termination rights”.

This topical focus was equally so in context of the Commission Services' consultation referenced above and accordingly we respectfully request that you carefully review and take full consideration of the ERC's 3 March response thereupon (a copy of which is appended hereto for ease of reference) in the context of this FSB consultation process. Annexed to this response there are some short, specific comments regarding questions 26 – 31 of this FSB consultation, together with some cross-references to the commentary which the ERC previously provided to the European Commission. At this stage, we do not have specific comments in respect of questions 32 – 34 of this FSB consultation.

Concluding remarks:

The ERC notes that the arrangements under consideration in the consultation proposals need to be carefully developed to take account of repo (and other types of financing) transactions, in addition to underlying cash securities transactions. The ERC considers that whilst it is right to seek the orderly resolution of a failing institution, this objective must be balanced against the market need for prompt closeout so as to mitigate the risk of adverse market movement during the period of suspension. The imposition of rigid or ill defined constraints could serve to impede established market practise for the efficient (repo) financing of securities positions.

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.

The ERC appreciate the valuable contribution made by the FSB's examination of the issues articulated in this consultation paper and would like to thank the FSB 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 flourish extending to the right.

Godfried De Vidts

Chairman

ICMA European Repo Council

cc : *ICMA European Repo Committee*
ICMA European Repo Operations Group

Specific comments regarding FSB consultation questions and cross-references to the ERC's earlier European Commission consultation response

The questions in the FSB's consultation which pertain to Annex 8 are laid out on pages 22 – 23.

FSB Questions for public consultation:

26. *Please give your views on the suggested stay on early termination rights. What could be the potential adverse outcomes on the failing firm and its counterparties of such a short stay? What measures could be implemented to mitigate these adverse outcomes? How is this affected by the length of the stay?*

- A. Any suspension of close out netting rights alters the measure of risk to which a party is exposed. In a repo context, this would result in a requirement for increased collateral to account for market movement during/post the period of suspension and thus has clear consequences on the cost and therefore the attractiveness of this essential form of short financing. Furthermore costs may also arise in case new measures adversely impact the efficacy or enforceability of netting, with consequent impacts on regulatory requirements and/or legal certainty. For these reasons the ERC regards the imposition of a temporary suspension of close out netting as undesirable. If there is, nevertheless, to be any form of suspension of rights it is essential that this should be both clearly defined and as limited as possible in terms of time frame.

Our views on these matters are further elaborated in the first four bullet points under section A of the commentary in the ERC's appended response to the European Commission consultation.

27. *What specific event would be an appropriate starting point for the period of suspension? Should the stay apply automatically upon entry into resolution? Or should resolution authorities have the discretionary right to impose a stay?*

- A. It is important to identify a clear point from which the suspension would take effect and that the market is able to clearly understand exactly what is meant by this. In addition, the methods of notification of any suspension must be accessible and clear.

Our views on this are also reflected in the 4th bullet point under section A of the commentary in the ERC's appended response to the European Commission consultation.

28. *What specific provisions in financial contracts should the suspension apply to? Are there any early terminations rights that the suspension should not apply to?*

- A. Understanding that the purpose of the suspension is to provide the resolution authorities with the time to select and transfer assets and liabilities, any suspension should be limited to those close out rights arising solely by virtue of the use of the transfer powers of the resolution authority. Any close out rights arising by reason of other termination triggers should not be not impeded.

Our views on this are also reflected in the 5th bullet point under section A of the commentary in the ERC's appended response to the European Commission consultation.

29. *What should be an appropriate period of time during which the authorities could delay the immediate operation of contractual early termination rights?*

- A. Any form of suspension of rights should be both clearly defined and as limited as possible in terms of time frame.

Our views on this are also reflected in the 4th bullet point under section A of the commentary in the ERC's appended response to the European Commission consultation.

30. *What should be the scope of the temporary stay? Should it apply to all counterparties or should certain counterparties, e.g., Central Counterparties (CCPs) and FMI, be exempted?*

- A. The exclusion of some counterparty types from the suspension would create competitive distortions; present arbitrage opportunities; and result in a misalignment with the rest of the market, which would undermine its stable functioning.

Our views on this are also reflected in the 6th bullet point under section A of the commentary in the ERC's appended response to the European Commission consultation.

31. *Do you agree with the proposed conditions for a stay on early termination rights? What additional safeguards or assurances would be necessary, if any?*

- A. The ERC supports those safeguards which aim to prevent resolution authorities from 'cherry picking' rights and liabilities under protected market arrangements, including title transfer financial collateral arrangements, set off arrangements, netting arrangements and structured finance arrangements.

During the period of suspension, the resolution authorities may transfer covered rights and liabilities to a private sector purchaser or another entity; or decide that such rights and liabilities will remain with the residual, 'failed' bank. If the former is the case, the ERC is concerned that there are robust and transparent criteria which such transferee must meet, at the very least in terms of its solvency. The ERC is also keen to ensure that any hardening periods (in which transactions are vulnerable to being challenged) with respect to relevant insolvency procedures are not 'reset' as a consequence of any transfer.

Our views on this are as reflected section B; and also in the 7th bullet point under section A of the commentary in the ERC's appended response to the European Commission consultation.

32. *With respect to the cross-border issues for the stay and transfer, what are the most appropriate mechanisms for ensuring cross-border effectiveness?*

- A. At this stage, we do not have specific comments in respect of this question.

33. *In relation to the contractual approach to cross-border issues, are there additional or alternative considerations other than those described above that should be covered by the contractual provision in order to ensure its effectiveness?*

- A. At this stage, we do not have specific comments in respect of this question.

34. *Where there is no physical presence of a financial institution in question in a jurisdiction but there are contracts that are subject to the law of that jurisdiction as the governing law, what kind of mechanism could be considered to give effect to the stay?*

- A. At this stage, we do not have specific comments in respect of this question.

APPENDIX

ICMA EUROPEAN REPO COUNCIL

DG Internal Market and Services
Directorate H – Financial Institutions
Unit H1 – Banking and Financial conglomerates
European Commission
SPA2, 1049 Brussels

3 March 2011

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: Technical details of a possible EU framework for bank recovery and resolution

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 DG Internal Market and Services working document on the technical details of a possible EU framework for bank recovery and resolution, published on 6 January.

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. 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

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

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](#).

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 ICMA Global Master Repurchase Agreement (GMRA or Agreement)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 which meets certain other requirements. Accordingly, ICMA obtains and annually updates legal opinions on the GMRA from 62 jurisdictions worldwide. These opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole.

The ERC notes that on 20 October, 2010, the Commission announced its plans for an EU framework for crisis management in the financial sector. Further to this, DG Internal Market and Services are now consulting on the technical details of such a framework. The ERC further notes that the objective of this consultation is to inform the preparation of a formal Commission legislative proposal scheduled for adoption in June 2011.

Commentary:

Whilst there are many interesting issues discussed in this consultation paper, the ERC is for now going to primarily restrict its focus to those aspects that bear most directly on repo. As the ERC sees it, the particularly pertinent matters are those relating to the temporary suspension of rights.

A. Temporary suspension of rights:

Section G12 of this consultation proposes a suspension of "... payment or delivery obligations pursuant to any contract". The ERC notes that it is important to clarify that such a suspension would have to operate on a reciprocal basis in order to be equitable.

At G13 this consultation proposes a "...temporary suspension of all close out rights of any party under a netting arrangement with a failing credit institution that arise solely by reason of an action or anticipated action by the resolution authority...". Whilst the ERC understands that the purpose of such suspension would be to give resolution authorities the benefit of a short time to decide which assets and liabilities should be transferred and to effect the transfers, it considers that the following observations merit detailed and careful consideration as this proposal is progressed:

- Close out netting is an important legal mechanism through which exposures (and therefore risks) may be reduced between counterparties. The importance of such a risk mitigation tool in supporting the stability and efficiency of the financial system has been consistently recognised and supported by policy makers. Any suspension of close out netting rights alters the measure of risk to which a party is exposed. In a repo context, this would result in a requirement for increased collateral to account for market movement during/post the period of suspension and thus has clear consequences on the cost and therefore the attractiveness of this essential form of short financing. In considering the implication of this, it is important to note that this extra

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.

collateral cost will be borne throughout the life of all repo transactions subject to the possible application of suspension constraints, notwithstanding that the incidence of any actual exercise of the suspension power may prove to be an extremely rare occurrence.

- Furthermore, if there was any disruption to the efficacy or enforceability of netting such that institutions would be unable to reduce their regulatory capital requirement under the Basel capital regime by relying on close out netting under a master agreement such as the GMRA, the burden of finding additional collateral would be exacerbated by a need to raise additional capital. The ERC is keen to ensure that the legal certainty of such netting arrangements is protected and that there are no unintended consequences in this regard. In case it arises, this would again be an ongoing cost, regardless of the contingent nature of the legal uncertainty occasioned by the creation of a suspension power.
- For the reasons set out above, the ERC regards the imposition of a temporary suspension of close out netting as undesirable. Once a termination event occurs, a party should be able to manage its credit and market risk in relation to its positions with the relevant failing counterparty, based on its assessment of market conditions and the situation of the counterparty. It must be able to take action to mitigate market risk by closing out such positions, without delay. The risk of market movement is very real, as the suspension would act in relation to just those contracts concerned, whilst the market as a whole would remain open – and be cognisant of the imposition of the suspension.
- If there is, nevertheless, to be any form of suspension of rights it is essential that this should be both clearly defined and as limited as possible in terms of time frame. Any such suspension should not be capable of extension by the resolution authorities or otherwise. The consultation suggests that any suspension should last no longer than forty-eight hours after the time the suspension is notified; or 5pm on the business day following the day of notification (whichever period is longer). The ERC is pleased to note that the consultation recognises the importance of identifying a clear point from which the suspension would take effect. It is important for the market to understand what is meant by ‘the time the suspension is notified’. In addition, the methods of notification set out in G10 of this consultation must be accessible and clear.
- Central to the GMRA’s netting provisions are the Events of Default which trigger the termination and closing out of the Agreement. The consultation proposes a suspension of all close out rights that “arise *solely* by reason of an action or anticipated action by the resolution authority”. The ERC is keen to ensure that this does not impede close out rights arising by reason of other termination triggers. Any disruption to such rights would further undermine the legal certainty and risk mitigation capabilities of the Agreement. It is therefore important to clarify what form of resolution action is included within this condition. If the purpose of the suspension is indeed to provide the resolution authorities with the time to select and transfer assets and liabilities then the suspension should be limited to a suspension of close out rights arising by virtue of the use of the transfer powers of the resolution authority.
- This consultation asks whether any classes of counterparty should be excluded from the scope of the suspension of close out netting. Examples given include CCPs and payment and securities settlement systems that fall within the scope of the Settlement Finality Directive. The ERC is concerned that the exclusion of some counterparty types from the suspension would create competitive distortions; present arbitrage opportunities; and result in a misalignment with the rest of the market, which would undermine its stable functioning.

- During the period of suspension, the resolution authorities may transfer covered rights and liabilities to a private sector purchaser or another entity; or decide that such rights and liabilities will remain with the residual, 'failed' bank. If the former is the case, the ERC is concerned that there are robust and transparent criteria which such transferee must meet, at the very least in terms of its solvency. The ERC is also keen to ensure that any hardening periods (in which transactions are vulnerable to being challenged) with respect to relevant insolvency procedures are not 'reset' as a consequence of any transfer.
- This consultation notes that "If the rights and liabilities covered by a netting arrangement remain with the relevant credit institution, a person may exercise all rights under that agreement". This applies on the expiry of the suspension or prior to such expiry if the resolution authority so notifies the counterparty. It is not clear whether close out netting may be enforced at this point by reason of the resolution action, or not. Further detail is again also required in respect of the method of notification.

B. Partial transfers: safeguards for counterparties

The ERC is pleased to note the safeguards proposed within this consultation paper which aim to prevent resolution authorities from 'cherry picking' rights and liabilities under protected market arrangements, including title transfer financial collateral arrangements, set off arrangements, netting arrangements and structured finance arrangements.

Concluding remarks:

The ERC notes that the arrangements under consideration in the consultation proposals need to be carefully developed to take account of repo (and other types of financing) trades, in addition to underlying cash securities trades. The ERC considers that whilst it is right to seek the orderly resolution of a failing institution, this must be balanced with the market need for prompt close out so as to mitigate the risk of adverse market movement during the period of suspension. The imposition of rigid or ill defined constraints could serve to impede established market practise for the efficient (repo) financing of securities positions.

The ERC appreciate the valuable contribution made by the European Commission's examination of the issues articulated in this consultation 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,



Godfried De Vidts

Chairman

ICMA European Repo Council

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 2000¹).

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 Group² 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 2005³. 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 2009⁴) 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>