ICMA
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Continually Working to Develop Efficient and Effective

COLLATERAL MARKETS

An Occasional Paper prepared on behalf of the

European Repo Council

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This paper has been prepared by the International Capital Market Association (ICMA) on behalf of the ICMA European Repo Council (ERC). ICMA would like to acknowledge the various individuals and institutions whose early published works are referenced in this paper.

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Occasional Paper

ICMA European Repo Council

Continually Working to Develop Efficient and Effective Collateral Markets

The International Capital Market Association ("ICMA") is committed to serving the needs of its members through its activities as a trade association and as a self-regulatory organisation. The membership of ICMA includes issuers, primary and secondary market intermediaries, asset managers, investors and capital market infrastructure providers. The mission of ICMA is to promote resilient and well-functioning international debt capital markets; which are necessary for economic growth, and benefit both market participants and their clients. As one element of its work, ICMA is closely involved in Collateral Markets (defined for the purposes of this Occasional Paper as those markets for assets that are currently used, or are likely to be used, by market participants to collateralize a creditor's claim under normal market conditions) through the work of the ICMA European Repo Council ("ERC").

The ICMA ERC has become the industry representative body that has fashioned consensus solutions to the emerging, practical issues in a rapidly evolving marketplace, consolidating and codifying best market practice. The ICMA ERC also plays a significant role in nurturing the development of the repo market and supporting its wider use in Europe, particularly among banks, by providing education and market information: and the ICMA bi-annual survey of the repo market has become established, over more than a decade, as the only authoritative indicator of market size and structure and the dominant trends. ICMA is an active force in standardising repo documentation, with the Global Master Repurchase Agreement ("GMRA") being the most predominantly used standard master agreement for repo transactions in the cross border repo market.

Over the last few years, ICMA has focussed closely on collateral as a topic, having clearly recognised its increasing importance and how it effectively underpins the functioning of capital markets that provide the basis for economic growth. Concretely, at the beginning of 2012, ICMA convened the Collateral Initiatives Coordination Forum ("CICF"), which was conceived as a joint trade associations' body, in order to facilitate appropriate coordination across the private sector of all collateral-related initiatives. Whilst it has not proved easy to maintain the impetus for such a broad ranging body to act, this CICF initiative did lead to the production of the CICF's Collateral Fluidity White Paper, which was published on 7 November 2012.

The view explained in this White Paper was that the challenge is to mobilise efficiently the flow of collateral inside and between organisations, by eliminating barriers to collateral flows and the development of an efficient market infrastructure. The CICF proposed that known problems in European financial market infrastructures needed to be fixed, alongside the delivery of the major technological developments to realise both T2S and the shift to a standard T+2 settlement period. Furthermore, the CICF considered that without the effective phasing of proposed changes, serious adverse consequences for financial markets, and hence the real economy, could be anticipated as a result of inadequate collateral fluidity; and urged that the industry and policymakers should work together to deliver well thought out, suitably phased measures.

More broadly, ICMA prepared a paper for policy makers, published on 8 April 2013, entitled "Economic Importance of the Corporate Bond Markets". This outlined why corporate bond markets are so important for economic growth, for investors, for companies, and for governments, around the world; and why it is therefore essential that laws and regulations that affect them avoid any unintended adverse consequences that could inhibit those markets. In response to widespread concerns that the cumulative impact of current and proposed regulatory reform threatens to undermine core aspects of the economic functions of trading in the European repo and fixed income markets, ICMA then produced a paper, published on 29 October 2013, entitled "Avoiding Counterproductive Regulation in Capital Markets".

A core theme running through this latter paper was the importance of collateral and the extent to which changes to financial regulatory rules risk impeding the functioning of the European repo market, which serves as a primary channel for the circulation of collateral. In light of this, a further ICMA ERC paper, "Collateral is the new cash: the systemic risks of inhibiting collateral fluidity", was published on 3 April 2014. This describes the increasing importance of collateral and how it effectively underpins the functioning of capital markets which provide the basis for economic growth. It calls for regulators to consider the impact of financial regulation on the movement of collateral, highlighting the potential systemic risks of inhibiting collateral fluidity and the negative impact this could have on the stability and efficiency of capital markets.

These papers sit alongside, and are complementary to, other more specific papers produced by the ICMA ERC, including its continuing contributions to public consultations; and a number of other European repo market reports and white papers.

Furthermore, responsive to an initiative proposed by the ICMA ERC, on 15 July 2013, the Triparty Settlement Interoperability ("TSI") Participants, namely the ICMA ERC, Clearstream Banking S.A. ("CBL"), Clearstream Banking AG ("CBF"), Euroclear Bank SA/NV and Eurex Clearing AG, signed – in a ceremony hosted by the European Central Bank ("ECB") and observed by the European Commission – the TSI Memorandum of Understanding ("MoU"). Pursuant to this MoU the TSI Participants have agreed to engage in a project with the aim of establishing a comprehensive framework for TSI between the TSI Participants.

In the first instance, this project primarily creates the opportunity for Eurex Clearing to extend the connected settlement locations for its secured funding market GC Pooling product, to include Euroclear Bank alongside CBL/CBF; but it is also intended to create a framework suited for extension to include other participants. Pending completion of detailed feasibility studies and market consultation, TSI was envisaged to be delivered by the end of 2015.

Meanwhile, led by the direct involvement of its long-standing Chairman, Mr. Godfried De Vidts, the ICMA ERC has also been actively participating in the work of the ECB's Contact Group on Euro Securities Infrastructures ("COGESI"); which has itself been coordinating significant efforts focussed on enhancing the understanding of collateral requirements and the effectiveness of the Collateral Market.

Pertinently, on 15 July 2013, the ECB published a report entitled "Collateral eligibility requirements: a comparative study across specific frameworks". This report provides a comparison of the rules for the eligibility of collateral, covering (i) the collateral policies followed by different central banks (including European central banks, as well as the central banks of the United States and Japan), (ii) the regulatory frameworks in place and (iii) the practices of central counterparties (CCPs). It was prepared by COGESI in cooperation with the ECB's Money Market Contact Group ("MMCG"); and is aimed at improving transparency by highlighting the differences between, and similarities in, the collateral requirements faced by the financial industry.

Most recently, three new reports promoted by the Ad-hoc Group of COGESI on Collateral (composed of members of COGESI and the MMCG were published on 7 July 2014.

- Collateral eligibility and availability: Follow-up to the report on "Collateral eligibility requirements - a comparative study across specific frameworks" – COGESI, building on its July 2013 report on collateral eligibility requirements across various frameworks, has set out to qualify the overall supply of high-quality collateral assets in the current new report and to examine what portion of this supply is effectively available and usable for financial institutions. Estimations in this respect are derived from various studies on the global supply of collateral assets for financing arrangements.

  This new report in particular explains that a non-negligible portion of the overall supply of high-quality assets is not available for use as collateral, and not all of the available collateral is usable due to certain securities settlement limitations. Accordingly, the report aims to establish the level of the "real supply" of collateral in the market.

- Euro repo market: improvements for collateral and liquidity management – market participants in COGESI, and in particular those active in the repo market, have expressed the need for enhancements to existing settlement arrangements to better support collateral and liquidity management activities. Although a number of changes will be implemented with the go-live of T2S, additional improvements beyond T2S would allow the repo market to better support the mobilisation of collateral throughout the day. These improvements complement earlier initiatives stemming from the work of the Giovannini Group related to the integration of European clearing and settlement markets. This report sets out the objectives and specific measures for achieving a consistent and integrated market for securities clearing and settlement in the euro area.

  The objectives are twofold: first, to facilitate a more efficient mobilisation of collateral, in particular on a cross-border/cross-system basis in the euro area; and second, to facilitate the use of collateralised transactions at end-of-day for treasury adjustment operations. To meet these objectives, a set of actions are proposed together with a more detailed set of recommendations and principles to facilitate implementation. Progress on the deliverables will be regularly monitored by the ECB, via the COGESI forum, to ensure that the proposed actions are implemented in a timely manner and consistent with the related recommendations set out in this report.

- Improvements to commercial bank money (COBM) settlement arrangements for collateral operations – the objective of this report (prepared based on input from a joint group of ERC and EBF members) is to explore current settlement practices in commercial bank money (CoBM) and propose recommendations to support "better use of collateral", in particular to remove structural constraints and inefficiencies in the settlement of collateral operations in CoBM. In doing so, the report focuses on trades with same-day (T+0) settlement of securities, which is required for the daily management of liquidity, resources (cash/securities) and collateral.

Also, importantly, in May 2014 the ECB removed the repatriation requirement, which had been part of the correspondent central banking model ("CCBM") since its establishment in 1999; and required Eurosystem counterparties to transfer assets to the respective issuer central securities depository before they could be used as collateral for Eurosystem credit operations. Abolition of the repatriation requirement eliminates the need to move assets from the investor securities settlement system ("SSS") to the issuer SSS in CCBM operations. This brings increased operational and cost efficiency; and it will facilitate the use of (i) a combination of CCBM and links and (ii) triparty collateral management services on a cross-border basis via the CCBM and will also enable the use of euro-denominated collateral issued in non-euro area EEA countries provided that the collateral meets Eurosystem eligibility requirements and certain settlement conditions are met.

Prospectively, starting in September 2014, the ECB will introduce the use of cross-border triparty collateral management services; allowing Eurosystem counterparties to manage collateral assets in an efficient manner via a triparty service provider. These services have been supported by a small number of Eurosystem National Central Banks, in some cases for many years, with their domestic counterparties in the context of Eurosystem credit operations; whilst the Eurosystem is now working on the introduction of a framework that also supports the use of such triparty services on a cross-border basis via the CCBM.

There is no doubt that there are important interactions between central bank operating frameworks and Collateral Markets. ICMA's semi-annual surveys of the European repo market, which are conducted by the ICMA Centre at the University of Reading in the UK at the request of the ICMA ERC, are the only authoritative source of data on the size and composition of the European repo market. Events such as the introduction of the LTRO have been considered to alter the size of the market, but it is far from easy to identify how much moves in the market related to one factor or another. The latest survey, based on repo positions held as at 11 June 2014, shows a year on year contraction in the market on a constant sample basis, reflective of changed market conditions and the balance sheet stresses which leading banks are experiencing in light of new regulations.

The ICMA clearly perceives that collateral is a topic of great importance and that it is essential to encourage the existence of efficient and effective Collateral Markets in the EU. In this context, the ICMA applauds associated public sector efforts which have been made to date; and recommends a thorough review of the above mentioned programme of private and public sector efforts to enhance Collateral Markets.

The ICMA believes that there is a significant opportunity to further coordinate efforts in this arena, both by bringing the efforts of the ICMA ERC to the attention of the public sector and by seeking to ensure that there is full cooperation across the public sector; not only with regulators but also including a close harmonisation of the respective efforts of the Bank of England's SLRC and the ECB's market contact groups – the BMCG, COGESI and the MMCG.