International Capital Market Association

ICMA EUROPEAN REPO and COLLATERAL COUNCIL

European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07
France

28 February 2018

Dear Sirs,

Re: ESMA Consultation on Draft Guidelines on Anti-Procyclicality Margin Measures for CCPs

In my capacity as the Chairman of the International Capital Market Association's (ICMA's) European Repo and Collateral Council (ERCC), I'm writing to draw your attention to a point requiring careful consideration in the course of your important work in relation to the application of EMIR's provisions for anti-procyclicality margin measures for CCPs.

The significant role played by CCPs in the European repo market:

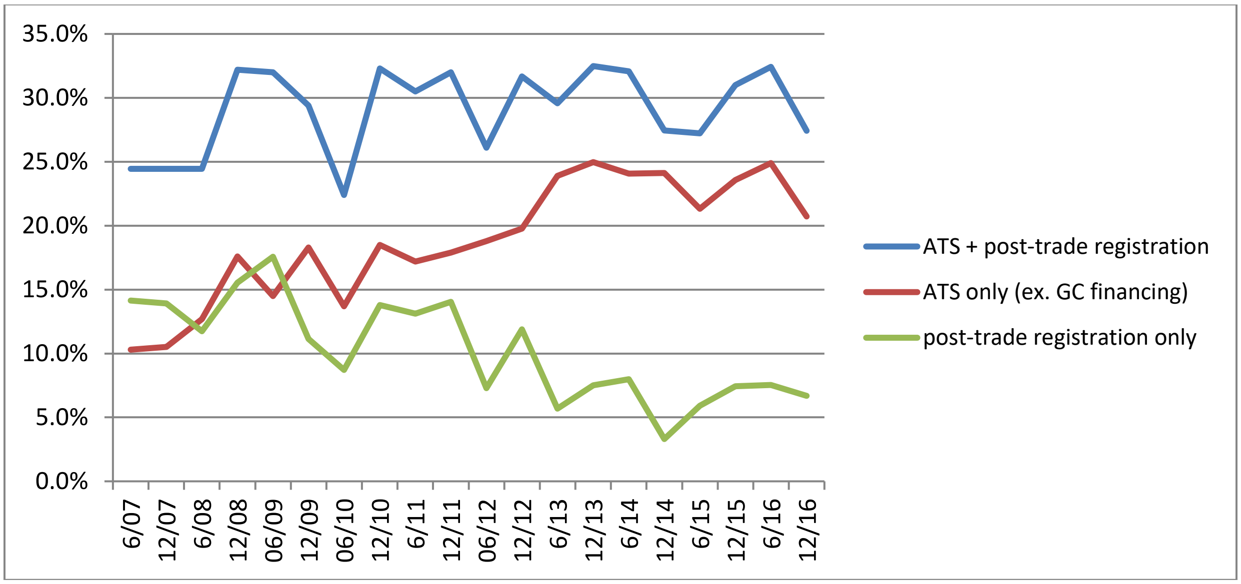
Over the course of recent years there has been much focus given to the development of a regime for the central counterparty (CCP) clearing of derivatives, which in the EU has been implemented within the context of the, so-called, European Market Infrastructure Regulation (EMIR).

In examining ways in which the application of this regime may best be evolved over time, one important consideration to be kept carefully in mind is that CCPs do not only provide central clearing services in respect of derivatives. In particular, the ICMA ERCC wishes to draw your attention to the fact that CCPs clear a very significant proportion of the European repo market. The ICMA's semi-annual survey of the European repo market suggests that about 30% of outstanding repos by value are cleared across a CCP (see Chart). The proportion of repo turnover cleared across a CCP is, however, understood to be significantly higher, because those repos cleared by CCPs are predominantly short-term transactions (the ECB's money market survey suggests in the order of 70%).

Most CCP-cleared repos are negotiated on automatic repo trading systems such as BrokerTec, Eurex Repo and MTS. However, repo negotiated directly between parties or via a voice-broker can also be registered with a CCP post trade. The principal CCPs clearing repos in Europe are LCH-Clearnet Ltd in the UK, LCH-Clearnet SA in France, Eurex Clearing in Germany, Cassa di Compensazione e Garanzia (CC&G) in Italy and BME Clearing in Spain.

It is very important to keep clearly in mind that repos are very different in nature from derivatives. In a repo the sale of the collateral security at the opening of the repo represents an exchange of principal, which is subsequently reversed upon the completion of the repurchase at the closing of the repo. The associated margining relates to the collateral security, seeking to ensure that the amount of the collateral is always sufficient to cover the principal lent against it. This is quite different from the case of a typical derivative, in which there are notional principals and the margining relates to the gain or loss as the value of the derivative fluctuates. The very different profile of these asset classes inevitably gives rise to the need for differently formulated policies, suitably tailored to the relevant risk management considerations.

Chart: Evolution of business cleared across CCPs



Source: ICMA

Besides this, CCPs are themselves significant users of the repo market. Much of the margin being held by CCPs pursuant to the trades they are clearing is received by them in the form of cash. To safely invest this cash CCPs utilise reverse repo transactions, so that they hold high-quality liquid securities (typically EU government bonds) as collateral against their investments. As well as being a secure way to invest, this use of the repo market facilitates the CCPs being able to readily adjust up and down the size of their investment, in response to the continuous fluctuation occurring in the cash margin balances they hold. And, in case of need, it is the repo market to which CCPs will turn in case they need to rapidly realise the value of securities margin held, against a participant default.

To complete the picture, it is also necessary to recognise that use of the repo market is the primary way in which CCP participants will themselves ensure that they have available the necessary cash and/or securities to place as margin with the CCPs, again adjusting their margin balances on a daily basis as their positions and applicable margin valuations fluctuate.

In summary, maintaining a smoothly functioning repo market is an essential adjunct to putting in place regulations which call for collateral to be used to mitigate risks, as in the case of EMIR and several other financial regulatory reforms enacted in recent years. The aggregate effect of measures across markets needs to be carefully assessed, so as to ensure that a focus on managing one risk – the procyclicality of CCP margins – does not inappropriately give rise to other risks.

Anti-procyclicality margin measures for CCPs:

As detailed by ESMA in this consultation paper, EMIR requires that CCPs, to the extent possible, take suitable measures to limit the procyclical effects of their margin and haircut policies; and the related December 2012 Regulatory Technical Standards (RTS) go some way to specifying how this is to be done. This current consultation is a single rulebook initiative whereby ESMA is seeking to put in place guidelines to promote consistent and uniform application of these EMIR provisions and the relevant RTS.

The ICMA ERCC clearly understands why it is that EMIR includes these particular provisions and recognises that they have a valuable role in creating a suitable, stable CCP clearing framework. The RTS, and the current exercise to refine its application across the EU, helps to provide important clarity regarding the ways in which CCPs operationalise these provisions. It will be beneficial if this enhances predictability and makes it easier to model how CCP's margin policies will behave under varying market conditions, including times of stress. And, it is appropriate that these policies include some degree of dampening of procyclicality, with margins calibrated to include some stress volatility and thus not in a way which would cause them to escalate over-dramatically during stress times.

Nevertheless, the ICMA ERCC also notes that it is inevitable that having risk sensitive margin models will mean there is some degree of procyclicality and recognises that this would cause market participants to manage the potential implications of changes in risks. This bears upon the calibration of the anti-procyclicality measures and, for this to operate smoothly, needs to be coupled with appropriate levels of transparency with respect to CCPs risk margining models.

Furthermore, the ICMA ERCC wishes to emphasise that it is important to pay very careful attention to the calibration of anti-procyclicality measures. The more that margin or haircut levels are increased, in order to boost the level of anti-procyclicality, the higher the disincentive to use CCP clearing. But, any such avoidance of CCP usage would itself create costs and instability thorough increases in basis or unhedged risks, to the detriment of end users and the broader real economy. Past experience shows that if the cost of CCP usage gets pushed too high, including through the imposition of excessive haircut levels, business flows do alter and the benefits of CCP clearing are then lost.

Finally, the ICMA ERCC observes that specific care and thought will be needed to correctly assess the appropriate application of these concepts in the case of linked CCPs.

The ICMA ERCC's focus on trying to look at all angles of the issue and strike a balance stems from these experiences of the ways in which CCP margin levels do impinge upon repo market behaviours. Given the outline provided above regarding the significant role played by CCPs in the European repo market, it is only natural that this should be so.

Conclusion:

The ICMA ERCC fully supports the need for the EU to have in place an adequate regime to provide for CCP clearing and recognises the appropriate role for anti-procyclicality measures in CCP margining policies. Yet, it is also essential that these are designed in such a way that they do not cause unnecessary incremental friction in the well-functioning of repo/collateral markets, which play a vital role at the heart of the financial system and underpin the effective operation of CCP clearing – providing an essential service to both CCP participants and the CCPs themselves. Accordingly, the ICMA ERCC considers it important that great care be taken to fully assess the way in which such anti-procyclicality measures are calibrated.

We would be happy to discuss these matters further and look forward to hearing from you at your earliest convenience.

Yours faithfully,

Godfried De Vidts
Chairman
ICMA European Repo and Collateral Council

Appendix:

ICMA ERCC Background

Since the early 1990's, the International Capital Market Association (ICMA) has played a significant role in promoting the interests and activities of the international repo market, and of the product itself.

The European Repo Council (ERC) was established by the ICMA in December 1999, to represent the cross-border repo market in Europe and 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.

Consistent with the fact that it is repo desks which can increasingly be equally considered to be collateral desks, it has been the ICMA ERC which has served to guide the ICMA's work on collateral, providing support to its broader efforts and driving many of the ICMA's specific collateral related initiatives. Thus, just as repo and collateral are intimately related in the market, so the ICMA ERC and the ICMA's work on collateral are also intimately related. In recognition of these intimate relationships, with effect from 4 December 2015, the ICMA ERC has been renamed as the ICMA ERCC, the "European Repo and Collateral Council".

The ICMA ERCC 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. The ICMA bi-annual survey of the European 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 the standardisation of repo documentation. The Global Master Repurchase Agreement (GMRA) is the most predominantly used standard master agreement for repo transactions in the cross border repo market.

Membership of the ERCC is open to ICMA members who transact repo and associated collateral business in Europe. The ICMA ERCC currently has around 100 members, comprising the majority of firms actively involved in this market.