ICMA
International Capital Market Association

ICMA ERCC Response to the Bank of England Discussion Paper on Transitioning to a repo-led operating framework

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Introduction and summary of response

ICMA is pleased to have the opportunity to respond to the Bank of England's Discussion Paper on *Transitioning to a repo-led operating framework*. ICMA us fully supportive of the Bank's core objectives of maintaining monetary and financial stability and welcomes the outreach for feedback on its plans to transition to demand-driven framework.

In order to formulate its response, ICMA convened a dedicated *Taskforce* (the "Taskforce") of member firms from its European Repo and Collateral Council (ERCC) that are active in the sterling repo market and regular users of the Sterling Monetary Framework ("SMF participants"). This constitutes a significant number of the most active banks in the sterling repo and money markets, including Gilt-edged Market Makers (GEMMs). Individual members of the Taskforce include Heads of Repo Desks, sterling repo traders, as well as senior operations experts.

The response highlights a number of key themes and recommendations that can be considered as broadly consensus views across SMF participants, and which the Taskforce would urge the Bank to consider addressing in order to achieve a successful transition to the framework:

- Both the Short-Term Repo (STR) and Indexed Long-Term Repo (ILTR) operations should be settled on a delivery-versus-payment (DVP) basis, along the lines of a triparty model.
- The current free-of payment (FOP) framework, requiring prepositioning of collateral, and payment late in the day, is a deterrent to using both the STR and ILTR operations, and could be more so in stressed market conditions.
- Moving to a triparty model would also allow for partialing, which would decrease operational risk.
- The current FOP frameworks could equally be viewed as a drain on liquidity as much as a source of liquidity.
- The process for confirming collateral eligibility (ILTR) should be significantly expedited and automated.
- More flexibility in the ITLR facility in terms of tenor would make it more attractive as a liquidity management tool. This could be in the form of alternative tenors, or the ability for early repayment.
- The ease of access and functionality of the Btender and Collateral Management Portal (CMP) systems could be improved, including with respect to collateral substitution and margining. The existing processes are manually intensive and difficult to operationalise.
- Significantly longer STR tender windows would be welcomed. There appears to be no reason for limiting this to 30 minutes. Furthermore, by referencing the STR rate to the

Bank Rate, there would be no reason to move the window on days of Monetary Policy Committee (MPC) meetings.

All of these points, and more, are discussed in the responses to the individual questions below. We hope that the Bank finds these constructive recommendations helpful and supportive of its policy objectives.

ICMA would very much welcome the opportunity to discuss this response with the Bank, to answer any questions that may arise, or to provide further clarification on any of the points outlined. If the Bank would find it helpful, we would like to propose a follow-up meeting or call, where Taskforce members would be able to provide direct feedback.

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving around 620 members in almost 70 jurisdictions globally. Its members include private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks. ICMA provides industry-driven standards and recommendations, prioritising three core fixed income market areas: primary, secondary and repo and collateral, with cross-cutting themes of sustainable finance and FinTech and digitalisation. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

The ICMA European Repo Council

The ICMA European Repo and Collateral Council (ERCC) is the industry representative body that fashions consensus solutions to emerging, practical issues in a rapidly evolving marketplace, consolidating and codifying best market practice. The ERCC is also responsible for promoting the wider use of repo in Europe by providing information and education. ICMA is an active force in standardising repo documentation, and sponsors the Global Master Repurchase Agreement (GMRA), which is the most predominantly used master agreement for repo transactions in cross border markets.

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The overarching framework

Question 1: *Our framework is designed to be robust to changes in the demand for reserves – which might be slow-moving or rapid; long-lived or short-lived. Are there any adjustments we could make to bolster the robustness of our framework for supplying reserves to changes in firms' demand?*

Participants provide a number of recommended adjustments to bolster the robustness of the framework particularly in response to changes in the demand for the reserves. The most critical of these would be to amend the operational structure of the SMF facilities (both STR and ILTR) to a delivery-versus-payment (DVP) triparty model. This would help to address a number of identified vulnerabilities in the existing free-of-payment (FOP) pre-positioning model, that could undermine the successful transition to a demand-driven framework for reserves:

(i) Pre-positioning, both for Level A collateral (STR and ILTR) and non-Level A (ILTR) is expensive, requiring intraday drawdowns on unsecured borrowing. This could be a disincentive to using the facilities. Providing for DVP for all eligible securities with an ISIN[1] would vastly enhance the usability of the SMF, making the operations function as true repo facilities, rather than collateralised loans. Participants also note that not only does the current framework require pre-positioning of collateral, but the cash received is often late in the day, extending the period of the effective liquidity drain.

(ii) The inability to make partial deliveries creates additional operational risk for participants. A triparty model would help to support partialing.

(iii) The collateral substitution process is operationally intensive and therefore difficult to automate. A triparty model would help solve for this.

A further proposed enhancement to the framework, which would also be consistent with transitioning to a triparty repo model, is providing for more comprehensive collateral schedules as well as improving the process for verifying or requesting collateral eligibility. It has been noted that the collateral eligibility process can take as long as six months, which would be problematic if the ILTR is to become a business-as-usual facility. The ECB process, which can verify eligibility same day, has been cited as a more efficient example.

Finally, some participants have flagged concerns around possible stigma associated with the use of the SMF facilities: both the STR and the ILTR, but perhaps more so the latter. Much of this stems from its evolution from a back-stop facility in times of stress. They believe that this is less the case from the perspective of the Repo Desk, but lays more with Treasury and senior levels of management, who may be more sensitised to the reputational risk and market signalling associated with the use of certain central bank facilities. While they acknowledge that the Bank is making great efforts to destigmatize the use of the key SMF operations, perhaps more could be done in terms of the Bank's targeting, with the suggestion of something along the lines of a "Dear CEO "letter.

[1] Participants would make an exception for eligible securities without an ISIN, namely loans.

Related to this, participants have suggested that increased asset encumbrance levels from using the SMF, particularly Level B and C collateral, could draw unwarranted attention from credit rating agencies. Here banks may need to consider engaging with CRAs to ensure that they, too, are on board with an increased reliance on central bank funding being the “new normal” and not a cause of concern.

However, it is important to clarify that this view on potential stigma attached to the SMF is not shared by all participants, many of whom feel that the Bank has already done enough to make its intentions clear and for its facilities to be considered as normal liquidity management tools.

Question 2: *What are the key risks to our framework's effectiveness at achieving our stated policy aims? How should the Bank address these risks during transition?*

Participants identify a number of potential risks to the effectiveness of the framework in achieving the Bank’s policy aims, which it may need to consider addressing as part of the transition. Again, the standout risk relates to the fact that the SMF operations are not true DVP repos, and are reliant on pre-position and FOP settlement. Participants suggest that this currently works well in the case of the STR, but could become more problematic as demand for reserves increases, increasing the requirement for and cost of intraday liquidity. Similarly, in the case of the ILTR, participants feel that the current model is sufficient in the case of a backstop facility, but is expected to be problematic in a business-as-usual scenario, particularly if the intention is that it be used at scale. Accordingly, the Bank should transition the STR and ILTR to a DVP triparty repo model.

In the case of the ILTR, participants further identify risks related to the lack of clarity around collateral eligibility and the process for requesting eligibility. As proposed in the response to *Question 1*, the use of more comprehensive collateral schedules and a far more efficient request process would help to mitigate this.

Another potential hindrance to the effectiveness of the ILTR is its lack of flexibility with respect to tenor. As participants’ demands for reserves change, and the mix of assets on their books (and those of their clients) shift, the effectiveness of the ILTR may depend on a wider range of funding options, with the need for both shorter (eg 1-month and 3-month) and longer (eg 12-month) tenors. It is noted that the ILTR’s predecessor, the LTR, offered a range of tenors (3-, 6-, 9-, and 12-month). Alternatively, or in addition, the Bank could address this risk by providing for the option of early repayment of ILTR repos. In the case of an early repayment option, it would also be important to seek clarification from the PRA that this optionality would not impact the LCR treatment of ILTR repos.

A further consideration lies more with participants and how they choose to utilize the SMF. For example, are the SMF operations used more by bank treasuries as a backstop funding tool, or, as the Bank is promoting, will they become more a business-as-usual funding source for the Repo Desk.

Related to this, some participants also point out that a limiting factor for the uptake of the operations is banks balance sheets, which naturally become constrained (or reassigned) for a host of reasons, particularly over reporting dates or in times of market stress. This would systematically reduce demand for the operations, particularly if banks can achieve balance sheet netting opportunities through market funding (even if at a higher cost). With this in mind,

some participants have suggested that making the STR centrally cleared could be a helpful enhancement. Although others feel that this would not create the level of benefits to warrant the operational lift, and at most should be only an option.

Finally, participants cite the operational challenges associated with the STR and ILTR as a potential risk to scaling up the use of both. These are explored in further detail later in the response (*Questions 11-14*).

Question 3: *How is the overall framework likely to affect private market activity, including the structure, activity, and pricing of money markets, and banks' incentives to provide repo lending to NBFIs in BAU and in stress?*

Participants point out that Banks will intermediate in the repo market to the extent that it is profitable and provides an adequate return on capital. This holds true both in business-as-usual scenarios and during times of stress. The SMF is designed to ensure as the demand for reserves increases, with the roll-off of quantitative easing, we do not see money market dislocations, or a significant widening of the repo-OIS spread across asset classes. As discussed in the responses to the previous questions, ensuring that the SMF operates more like a true repo facility will be important in this respect.

However, as also previously mentioned, bank balance sheet constraints will remain a decisive factor in the extent to which banks can intermediate, and therefore the transmission from the SMF to private market activity. Thus, dislocations and repo-spread widening will remain probable eventualities around reporting dates or in times of stress. Accordingly, the design and calibration of the Contingent Non-bank Repo Facility (CNRF) will be an important consideration (although this remains beyond the scope of this response).

Some participants have suggested that providing capital or leverage ratio relief for SMF reserves could help to support intermediation in periods where bank balance sheets are constrained, whole others feel that this may actually increase reliance on central bank funding to the detriment of market activity. Others suggest that a leverage ratio exemption for HQLA reverse repo would be more effective.

Question 4: *What are the key factors that may affect SMF participants' total ILTR and STR usage over the course of the transition?*

Ultimately, the demand for usage of the ILTR and STR will be driven by individual banks' business needs and the mix of assets that they are required to finance, as well as balance sheet capacity.

Participants have also suggested that a further consideration is the extent to which banks utilize the SMF purely as a business-as-usual source of liquidity, or whether they use it as a means to scale up their business, providing more financing to their clients, against a larger pool of assets, than they otherwise would. However, constraints on balance sheets would provide a natural limitation on such expansion, and again where some suggest that access to central clearing for the STR could be helpful.

Participants also note the intention of the PRA to review its liquidity and funding policy framework, including regulatory reporting, to ensure alignment with the Banks's proposed transition. Ensuring that use of the SMF does not have any detrimental impacts from a

regulatory capital or liquidity perspective will be important with respect to its usage, as well as addressing any stigma concerns that some participants may have.

Question 5: *For borrowing against Level A collateral specifically, what factors determine whether to use central bank facilities or private market alternatives, and if using central bank facilities, what factors determine the choice between the STR, ILTR and OSF? How might these evolve over time?*

In the case of Level A collateral, as with any collateral, the decision to use a particular funding source will be driven by commercial considerations. These include factors such as cost, haircuts, diversification of funding sources, client relationships, market conditions, balance sheet constraints, and term of funding.

With respect to cost, important considerations for participation when it comes to the SMF are haircuts, noting that the SMF haircut schedule is punitive relative to market rates, as well as intraday liquidity costs due to pre-positioning. The GBP cross-currency basis against other currencies can also be a driver when it comes to funding non-GBP collateral.

Participants cite a lack of flexibility as an important consideration, noting that the choice of either one-week or six-month funding is relatively limited, again s suggesting a need for a wider variety of tenors, as well as the possibility of early repayment for the ILTR.

Participants point out that the OSF is currently used in the case of necessity and generally for unexpected operational reasons, primarily due to its cost relative to the STR or typical market levels.

As highlighted by many Bank notices, it was noted that use of the OSF does not carry any stigma. However, participants did want clarification from the Bank as to whether it considers the OSF to be a standard business-as-usual liquidity tool, rather than an operationally driven backstop. And if the former, should the associated rate be less punitive. This has further led to a discussion around whether an additional tool in the SMF toolbox should be an overnight repo facility, based on Level A collateral, similar to the Federal Reserve's Standing Repo Facility (SRF). This may not necessarily be a daily facility, but rather something that could be used in response to unexpected shortfalls in reserves, such as over reporting dates. This would be seen as complementary to the STR, rather than replacing the OSF.

The ILTR facility

Question 6: *What factors determine the point at which borrowing in the ILTR on a regular basis becomes attractive relative to private market alternatives?*

Participants again point to the fact that usage of the ILTR is likely to be driven by a number of commercial considerations, in particular the expected rate compared to market rates for the same collateral, haircut levels, and the importance of flexibility in tenor.

Aside from the limitations listed in the responses to earlier questions, what participants feels makes the ILTR potentially more challenging to use as a reliable source of liquidity is uncertainty of execution. Under the Bank's proposed calibrations, given the current levels of excess reserves, this is unlikely to be a problem, and participants would not expect to hit the maximum allocation, making certainty of execution, and spread, predicable. This is particularly important in the case of Level B and C collateral, which can be difficult to finance in the market, especially at short notice. However, the concern is that in time, as reserve levels continue to normalize, the ILTR is likely to become more competitive. At this point, the risk caused by uncertainty of execution needs to be assessed against relying on market funding, which may also be commercially more attractive for the reasons already outlined. If so, the Bank may need to review the calibration of the ILTR, as well as the other features previously flagged (including collateral schedules, flexible tenors, and DVP).

Question 7: *How will the indicative changes to ILTR calibration (in terms of quantity and pricing) affect SMF participants' behaviour at the start of, and later on in, transition?*

This is partly answered in the response to *Question 6*. However, participants welcome the proposed recalibration of the ILTR with respect to the three dimensions of an increase in total reserves, an increase in the quantity of reserves available at the fixed minimum spreads, and a gentler upward sloping curve to ensure only a gradual rise in spreads. Participants feel that this is well calibrated for current levels of excess reserves, although suggest that this may need to be reassessed at a future point as this changes.

Question 8: *What factors determine whether to borrow against Level A, B, or C collateral in the ILTR? What relative amounts of Level A, B and C collateral do you intend to draw against? How might this evolve over time?*

As highlighted in the responses to previous questions, a number of factors will drive participants' incentives to use the SMF operations, and the collateral they allocate. These include the mix of bank (and client) assets, which can vary over time, banks funding needs, market conditions, balance sheet constraints, as well as relative pricing, haircuts, and the need for flexible tenors.

An additional consideration which has been raised as a point for clarification with respect to the ILTR is whether the Bank can alter the calibration of the facility for existing loans (say in terms of haircut or spread).

Question 9: *What factors affect SMF participants' ability to smooth demand across ILTR auctions?*

Participants suggest that this would require banks spreading their funding requirements over a series of auctions to avoid cliff-edge risks. However, for a lot of Level B and C collateral types, it can be challenging to fund these in the market, making it more attractive commercially to fund via the ILTR on an as needs basis, rather than holding off in order to smooth out their roll risk.

However, as already identified in the responses to previous questions, more flexibility in the ILTR in terms of different tenors, as well as the ability to make early repayments, would help to smooth demand across auctions.

Question 10: *How effectively does the indicative ILTR recalibration balance the need for the auction to be responsive to market conditions with sufficient predictability of allocation for participants?*

Please refer to the response to *Question 6* which addresses this point.

Operational and collateral

Question 11: *How do the SMF framework changes discussed in this paper affect your plans for pre-positioning collateral over the coming years, including the relative composition of Level A, B and C collateral? What factors will be most significant in these decisions?*

As previously outlined, this will depend on a number of factors, including individual banks' business models, evolving asset mix and financing needs, market conditions, balance sheet constraints, as well as commercial considerations such as price, haircut, and operational efficiencies.

However, as also previously described, pre-positioning is not optimal from a liquidity management perspective, in the case of all collateral types, and creates a natural constraint on usage. Participants explain that for every pound of reserves borrowed in the SMF, this creates an equivalent intraday financing need (in fact more, taking into account haircuts). In other words, in its current model, the SMF is as much a liquidity drain as it is a liquidity source. While, participants appreciate the historical reasoning for pre-positioning (essentially to enable the back to conduct sufficient due diligence in the event of a sudden and unexpected need to borrow at the Discount Window),[2] which is relevant in the case of assessing certain loan collateral pools, they do not believe that this is valid in the case of most other collateral, and certainly Level A and B.

Participants further note that the current process for substituting collateral is not real-time, which leads to further over-collateralization and a drain on liquidity.

Related to collateral encumbrance, some participants have highlighted challenges with respect to accounting for collateral assignment to various transactions and propose that the Bank take responsibility for this process, providing end of day reports, similar to triparty models. (see response to *Question 13*).

Effectively, taking all of these points into consideration, the current SMF model incentivizes participants to leave as little collateral as possible with the Bank. Hence the importance of transitioning to a true DVP triparty repo model, which would address these commercial and operational challenges.

Question 12: *What suggestions do you have on the current SMF operational arrangements to enhance efficiency further? Responses could consider operational risk, straight through processing collateral management and cash settlement or communications with the Bank*.

Most of the key suggestions that participants provide to enhance efficiency of the SMF, as well as to address operational risk, have already been outlined in the responses to previous questions, and include:

(i) A DVP triparty repo model, with clearer collateral eligibility schedules for Level B and C collateral.
(ii) An expedited process for determining or requesting collateral eligibility.
(iii) Supporting partial settlement.
(iv) Real-time collateral substitution.

[2] See: Paul Fisher: Liquidity support from the Bank of England – the Discount Window Facility (2012)

Participants further suggest enhancements to the margin process. These include more flexibility with respect to the being able to process substitutions prior to daily margin calls, and the ability to post cash collateral.

Also related to the margin process, it is noted that the Bank retains the right to make additional intraday margin calls. Here participants feel that it would be helpful to understand the basis and modelling for such calls.

Question 13: *We are seeking feedback on possible improvements to the Bank's documentation to support firms' operational engagement with the Bank. This includes the Bank's Market Operations Guide, operational process guides, loan pre-positioning guide w, and collateral eligibility framework. What information do you currently access and what improvements or additions do you suggest?*

Participants suggest that the SMF could be improved by the Bank providing daily reports outlining collateral assignment, mark-to-markets, and margin calculations, similar to triparty models.

In addition, it is suggested that a helpful addition to the Bank of England Money Market code could be high principles outlining the objectives of the SMF operations and how participants are expected to utilize the different operations.

Question 14: *How could current systems, such as Btender or the Collateral Management Portal (CMP), be improved to enhance participation in operations, streamline trade settlement and facilitate position management? Please briefly describe any additional features, adjustments or feedback that could support a more effective user experience and operational efficiency.*

Participants suggest that the Btender and CMP platforms could be combined into a single platform.

They further note that the Btender platform is difficult to log into, particularly for traders who do not use it on a regular basis (such as non-GBP traders covering for their GBP colleague). This could benefit from simplification.

Additionally, and enhancement to Btender access would be segregation within institutions. For example, Repo Desks and bank treasuries may require access to the various SMF operations for different business reasons, where it may not be appropriate to have full visibility across divisions. The ability to segregate access internally could be an important factor in facilitating greater business-as-usual usage of the SMF operations by Repo Desks.

Participants also query why the Btender window is only open for 30 minutes, which creates challenges for overly busy or resource constrained desks. They suggest opening the window for significantly longer (say from 8am).

Finally, and also related to the Btender window, participants question why this is moved on MPC meeting days. They suggest that the tender rate could be referenced to the Bank Rate, meaning that the window could be opened much earlier. It has been pointed out that modifying the STR to the ISTR would also be consistent with the transition of the old LTR to the ILTR.