ICMA EUROPEAN REPO COUNCIL

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid
Spain

27 September 2012

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: Joint Consultative Document "Margin requirements for non-centrally-cleared derivatives"

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 Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO") consultative paper "Margin requirements for non-centrally-cleared derivatives", as published on 6 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.

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 consultative paper seeks stakeholders' views on the formulation of consistent regulatory margin requirements across jurisdictions. The ERC also notes that whilst the margin requirements considered by this consultative paper are specifically concerned with non-centrally-cleared derivatives, they are nevertheless just one part of a much broader framework of requirements for the utilisation of collateral. Repo/collateral management desks brings together different internal collateral sources and allocate that firm-wide according to needs; whilst at the same time delivering available collateral securities to the market and sourcing required collateral securities from the market. Accordingly the ERC considers that as the repo market is the channel through which collateral flows, it is important to take into consideration a number of points identified from the perspective of leading repo market participants.

In context of this, the ERC has the following brief observations in relation to a few of the matters considered in the discussion paper.

Q1. What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (eg central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?

The ERC notes that the importance of collateral has grown over many years, but has accelerated significantly since the advent of the financial crisis in mid-2007. This is in no small measure related to the shift in risk appetite of market participants, with an increased demand amongst them to secure their credit risk exposures through the taking of high quality collateral. As you are quite clearly well aware, official policy makers have also significantly fuelled the demand for high quality collateral as they have advanced steps to make markets more robust, to reduce systemic risk and help mitigate the risks of any future financial crises. Amongst examples of these increasing demands are:

- increased focus on covered bond issuance by banks, secured against high-quality mortgage pools, as against senior unsecured issuance;
- increased use of repo funding to finance assets, including in context of an increase in the use of central bank financing;
- Basel requirements, to be translated in the EU through the CRR/D; introducing the holding of liquidity stress buffers – assets to satisfy these requirements comprise a short list of high-quality collateral;
- the shift of standardised OTC derivatives to CCP clearing, as required in the EU by EMIR, which will give rise to demands for significant amounts of initial margin (as well as some increase in variation margin amounts); and

[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.

- increased requirements to margin any bilateral OTC contracts (outside of CCP arrangements), incentivised by penal treatment of uncollateralised exposures in the CRR/D requirements.

With the equivalent G20 agenda demanding ever more collateral, including the need to collateralise bilateral trading between the buy- and sell-side, coupled with the downgrade of a substantial part of previously reasonable good collateral, it is widely perceived that the market will suffer from a shortage of high quality collateral. Whilst numerous studies have given estimates of the potential collateral shortfall which may be faced, inevitably nobody actually has the exact answer. Nevertheless, given the scale of the numbers involved there is no doubt that steps should be taken to ease the transition to new requirements, thus allowing markets some time to absorb and adapt. Providing for an extended phase-in period is one obvious way in which to facilitate the transition, without any need to compromise desired longer-term goals. It should nevertheless be considered that there should be a reasonable degree of coherence between the phasing-in of these requirements for non-centrally cleared derivatives and analogous requirements being mandated for centrally cleared derivatives.

Q3. Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?

The ERC considers that other specific criteria for determining exemptions may be appropriate. For example all forms of hedging activity offer potential economic benefits, so some easing of requirements may reasonably be considered for such transactions.

Q11. Are the proposed exemptions from the margin requirements for non-financial entities that are not systemically important, sovereigns, and/or central banks appropriate?

The ERC considers that the proposed exemption for non-financial entities that are not systemically important is appropriate. Nevertheless the ERC observes that in the first paragraph on page #9 of the consultative paper it is stated that:

"… Similarly, the BCBS and IOSCO broadly supported not applying the margin requirements in a way that would require sovereigns or central banks to either collect or post margin. Both of these views are reflected by the effective exclusion of such transactions from the scope of margin requirements proposed in this consultative paper."

The ERC considers that the inclusion of sovereigns and/or central banks within the scope of the proposed exemptions would be distortive for derivative traders. Traders can have significant sized positions arising from transactions with these types of counterparty, which they risk manage by economically matching their positions with other traders. The effectiveness of the position risk offset which they are able to achieve will be reduced in case there is an imbalance between the margin requirements imposed on the two sides of such matched positions.

Relating to the collateralisation requirements of central banks faced by market participants, the recent LTRO from the Eurosystem has somewhat increase the pressure on the availability of collateral. As a by-product of the welcome provision of liquidity for some market participants, residual liquidity generated has been placed in the Eurosystem's deposit facility by other financial institutions. However, these deposits are unsecured; and hence overall a substantial amount of collateral has been drained from the interbank market. Adoption of a solution to release such collateral, either through security lending or some other form of collateralisation of deposits, may decrease the pressure on interbank collateral without exposing the central bank community to undue risk. Whilst some sovereigns/central banks have already started such a process, it would be worthwhile to encourage others as it will benefit the recovery of the markets as a whole.

Q20. Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?

The ERC is pleased to note that the approach proposed is to permit a broader set of eligible collateral, including assets like liquid equity securities and corporate bonds, and to address the potential volatility of such assets through application of appropriate haircuts to their valuation for margin purposes. Particularly given the widely perceived squeeze on collateral already referred to in this response submission it is important that such an approach is adopted, as adopting a more restrictive approach would simply serve to exacerbate an already foreseeable problem. The ERC also notes the list of examples of eligible collateral types on page #22 of the consultative paper and that this list is not to be viewed as being exhaustive. The ERC observes that there are indeed further types of assets which may equally be suitable as eligible collateral, including high quality securitisations (ABS/MBS); credit claims; real estate; other metals; and ETFs; and that a number of these are already accepted in some circumstances, including under certain central bank collateral eligibility regimes.

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

The ERC highlights that the consultative paper calls (on page #24) for haircuts to "be set conservatively to avoid procyclicality." The ERC believes that this well intentioned regulatory approach is flawed and leads to a negative economic impact. Setting haircuts conservatively ensures that an excess cost has to be borne at all times when the selected haircut requirement is in excess of true economic requirements at that point in the cycle. The benefit which is supposed to offset this cost is that procyclical increases in haircut levels can be avoided as the cycle turns down and economic requirements increase. This however presupposes that the market will react to such a cyclical downturn simply by looking at the potential need for increases in haircut levels. In practice this is not the case and indeed the ERC believes that the adjustment of haircut levels in a down cycle is much less of a factor than the actual withdrawal of credit, which would not be avoided simply by having set a conservative haircut level. "Haircuts and initial margins in the repo market"[3], written by Richard Comotto of the ICMA Centre and published in February 2012, provides a much more detailed examination of this ERC point of view. The net effect is that mandated minimum haircuts will give rise to a cost, giving rise to a consequent reduction in investment levels and an associated negative real economy impact.

Q23. Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?

The ERC is concerned by the proposal to require that initial margin be exchanged on a gross basis, particularly since we understand that estimates regarding the amounts of high quality collateral which will need to be found in order to satisfy such a requirement are very large. Not only does this requirement drain collateral liquidity, but also it creates incremental risks of loss on the initial margin posted (as noted in the first line on page #25 of the consultative paper). This prompts the need for detailed attention to the protection of such margin balances, which will be complex to achieve in a legally robust manner, on a cross-border basis.

---

[3] Haircuts and initial margins in the repo market

Even in the seemingly simple case of an exchange of cash collateral the question arises of how to safely hold the cash. A deposit in a current account is costly, as it offers no return whilst still giving rise to a counterparty exposure against the bank where the account is held. Any form of reinvestment, such as in T-bills, gives rise to a different set of exposures and, particularly in the current environment, is still likely to offer only a very low or even negative yield. The ERC perceives that the benefits of adopting such a rigorous approach to the elimination of counterparty credit risk are likely to be more than offset by increased liquidity risks and the increased incidence of unhedged risks, as the cost of tailored OTC derivative hedges increase to such a level that they cease to be considered economically viable.

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

The ERC wishes to stress the fact that re-hypothecation and re-use are not synonymous. Re-hypothecation is a term that applies to pledging. Pledgors are said to hypothecate collateral to pledgees. Typically, the pledgee cannot use the collateral as the pledgor retains legal ownership. Re-hypothecation is a special case where the pledgor gives specific permission for the pledgee to use the collateral and is usually limited to financial assets. Nevertheless, the pledgor retains a security interest in the collateral. In repo (under the GMRA) there is sale, with full title transfer. Since no security interest is retained the security sold in the opening leg of the repo may be freely reused by the purchaser, as is the case with any other asset which he owns. This of course does not negate the fact that the purchaser has an obligation to resell when the date of the closing leg of the repo is reached; and must cover this obligation accordingly.

The ERC also notes that the operational risks of re-hypothecation have caused concern, but this does not apply to reuse. We appreciate that re-hypothecation is also worrying regulators because of leverage and interconnectedness and that re-use does carry the same risks, but in our view there are still important differences. Re-hypothecation is less transparent (because there is no sale) and it is, in some ways additional leverage, whereas re-use is often part of market liquidity management.

Q27. Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?

The ERC is particularly interested in international, cross-border business and in common with many others desires to see a coherent international regulatory framework, capable of efficiently accommodating such international business. Given this the ERC is pleased to see that the consultative paper seeks to address the need for such an international framework, but notes that it will be an on-going challenge to ensure that the concept of such a framework is not undermined by the detailed implementation of specific rules. Accordingly it will be important to arrange rigorous and timely peer review exercises, to continuously promote consistent application of any agreed framework.

Concluding remarks:

The ERC draws attention to the fact that, through ICMA, it is contributing to the development and work of the Collateral Initiatives Coordination Forum[4] (CICF), a joint trade associations' body established at the beginning of 2012. Bringing together a broad range of representation from right across the financial industry, the CICF provides a new and helpful channel for information sharing, education and joint industry endeavours in the field of collateral.

The ERC appreciates the valuable contribution made through the joint BCBS and IOSCO examination of the issues articulated in this discussion paper and would like to thank the BCBS and IOSCO for their 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

cc : ICMA European Repo Committee

---

[4] Collateral Initiatives Coordination Forum