ICMA EUROPEAN REPO COUNCIL

CPSS Secretariat	IOSCO Secretariat
Bank for International Settlements	C/ Oquendo 12,
CH-4002 Basel,	28006 Madrid,
Switzerland	Spain

25 June 2010

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: "Guidance on the application of 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs"

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 repo oriented aspects of the 12 May 2010 joint consultation paper, of the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) – "Guidance on the application of 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs".

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[1].

[1] The Global Master Repurchase Agreement (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 notes that on 12 May consultative guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties (RCCP) to OTC derivatives CCPs was announced jointly by the CPSS and IOSCO. 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.

1. *CCPs for products other than OTC derivatives*

The RCCP includes Recommendations concerning (1) legal risk; (2) participation requirements; (3) measurement and management of credit exposures; (4) margin requirements; (5) financial resources; (6) default procedures; (7) custody and investment risk; (8) operational risk; (9) money settlements; (10) physical deliveries; (11) risks in links between CCPs; (12) efficiency; (13) governance; (14) transparency; and (15) regulation and oversight. This consultation report proposes tailored guidance in respect of each of these except Recommendations (7), (9), (10) and (11).

The ERC notes that the report includes some limited guidance which aims to address issues that are not specific to OTC derivatives CCPs but are also relevant to CCPs for other types of products. This type of guidance is proposed in this report because the CPSS and IOSCO concluded that there is urgent need for such guidance on several issues in light of the lessons learned from the recent financial crisis.

The ERC observes that work to further identify the need for this type of guidance will be part of the comprehensive review of RCCP and other international standards for financial market infrastructures (FMIs) announced in February – into which the output from this consultation report will be incorporated. As repo market activities involve non OTC derivatives CCPs, the ERC very much looks forward to this future stage of the process and anticipates commenting further.

Also, issues that are equally applicable to other types of FMIs than CCPs (including the issues concerning money settlements and liquidity resilience of CCPs and other types of FMIs; and risks arising from links among FMIs) are not discussed in this report. The ERC notes that this scope limitation leaves a number of key issues aside at the current time, so again the ERC very much looks forward to seeing more on these topics and anticipates commenting further.

2. *CCP usage*

In 2009 the G20, supported by EU Member States, advocated maximum use of CCPs. However, the repo market had established the use of CCP clearing in Europe as early as 1999 – when LCH Ltd, supported by market practitioners in the repo market, created Repoclear. This was followed by Clearnet (later merged into LCH.Clearnet group), Eurex Clearing and CC&G. The ERC firmly supports the use of CCP clearing in repo markets and continues to take steps to promote its development.

CCPs are broadly accepted as a key tool in mitigation of counterparty credit risk in the OTC markets. Quite understandably the authorities are therefore pushing to make the fullest use of CCPs, whilst quite correctly appreciating that CCPs must themselves be subjected to very high risk management standards. If this latter aim is not adequately achieved the CCPs will themselves become a major source of risk. Given this public policy direction, it is an important component of the incentive structure that market participants should be able to rely upon CCPs and hence not have to treat their concentrated exposures to them in a way that would constrain their use – neither for capital adequacy nor for large exposure limit purposes. Any failure to adopt such an approach to the treatment of exposures to CCPs would undermine the incentive effect that is otherwise being pursued.

The ERC consider that non-discriminatory access to CCPs is an important element in an efficient and effective post-trade infrastructure. There needs to be fair and open competition between trading venues and/or bilateral voice or interdealer-brokered voice trades and this can only be achieved in an environment where such access rights are guaranteed.

One other aspect to which the ERC has devoted significant time is interoperability, particularly in the context of the CCPs for European tri-party repo transactions. A specific concern that has been highlighted by these efforts is that in pursuing interoperability other operational inefficiencies may be created. In particular, whilst reviewing proposals to create access to Eurex Clearing for both ICSDs the ERC has noticed that FOP transfers of collateral would be re-introduced into settlement of a market that was hitherto DVP.

3. *Adequacy of collateral*

The significant extensions of collateral requirements for OTC derivative exposures, both where these are moved to CCPs and for ongoing bi-lateral contracts - count amongst several contemplated measures that increase the demand for high quality collateral securities. Each such proposal needs to be developed on its merits, taking due account of the applicable risks. Nevertheless, the aggregate impact of proposals also calls for consideration. In case this aggregate impact becomes too great the outcome will be a market where the requisite collateral is inadequately liquid, leading to price distortions and the introduction of new risks – all of which may serve to undermine the very benefits which were sought.

Recognised throughout the crisis is the need for enhanced collateral management. As already mentioned above there is a direct link between the need for collateral management and liquidity. The forthcoming Basle review will include liquidity buffers that should be composed of the highest quality collateral. Although the goal is clear to all, the achievement of this may depend upon major market restructuring. We are currently still facing enormous problems with various types of collateral and the ERC feels the global regulatory reform may be impacted by the quality of future bond issues, not only from sovereign states but also from the corporate sector.

As a consequence the impact on the availability of adequate, quality collateral for the purposes of margin calls and default funds to CCPs for all products (fixed income, OTC derivatives, equities, futures…) may be less clear. It is conceivable that CCPs should also accept non government bonds in the future. The volume of calls for additional collateral due to adverse movements in the positions of OTC derivative markets, with current notional outstanding of US$ 615 trillion (see latest BIS Quarterly Review at http://www.bis.org/publ/qtrpdf/r_qt1006.pdf), may prove to be insurmountable.

The current regulatory reforms calls for increased use of central clearing facilities for eligible contracts from all regulated firms, expanding from the banking sector to the insurance and pension fund sector amongst others. Whereas some of this client base may have been willing to exchange non-government bonds for private issues of AAA rating this may no longer apply in the future. Hence the impact of the recommendations for variation margins, default funds and additional haircuts where applicable may not be as straight forward in the future, particularly taking into account the amount of cross-currency transactions that exist in both centrally cleared and bilaterally cleared transactions.

Closing Comments:

The repo product has been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of market standard documentation. 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 believes that the interests of all parties are best served if provisions applicable to repos are as efficient and effective as possible. In case the effect of well intended new measures proves to be a reduction in the attractiveness of repo markets the consequence will be more risk, increasing financing costs and thereby harm to 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 December 2009[2]) shows that collateral is not limited to European countries. Almost 25% 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 – in which regard the ERC is keen to see the work of the CPSS / IOSCO providing the applicable international standard to which regions and nations conform.

The ERC appreciates the valuable contribution made by the CPSS and IOSCO through their examination of the issues articulated in this consultation paper and would like to thank the CPSS 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

[2] https://www.icmagroup.org/ICMAGroup/files/59/59708fbd-0fcc-4838-bce8-0d29b4bc5586.pdf