

## EUROPEAN REPO COUNCIL

Prudential Policy Division  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

25 March 2010

Dear Sirs,

### **Response submission from the European Repo Council**

**Re: FSA Consultation Paper 09/29 – “Strengthening Capital Standards 3”**

#### **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 concerning one specific aspect of the FSA’s Consultation Paper 09/29 – “Strengthening Capital Standards 3”.

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 (the most prevalent version being GMRA 2000<sup>1</sup>).

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<sup>1</sup> The Global Master Repurchase Agreement (GMRA) 2000 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 10 December consultative proposals for implementing changes that are required following amendments to the EU Capital Requirements Directive (CRD) were announced by the FSA<sup>2</sup>. Whilst there are many interesting issues discussed in this FSA consultation paper, the ERC is for now going to restrict its focus to one particular aspect that is of particular concern to repo market participants.

### ***Central Counterparty Exposure for Large Exposure Purposes***

CRD Article 30(4) provides for a national discretion to allow asset items constituting claims and other exposures on recognised third country investment firms and recognised clearing houses and exchanges, to be subject to the treatment in Article 106(2)(c). Annex 3 of this FSA consultation paper indicates that this discretion is not being applied; and the related text is therefore struck out (in appendix 2 at 10.6.3 R (9)).

On the face of it this deletion of the discretion from BIPRU text appears to indicate that the FSA intends that exposures to central counterparties (CCPs) would be subject to the 25% large exposures limit. If this is indeed the case it is of significant concern, particularly given the much increased significance of CCPs arising from various ongoing official actions.

On the other hand, the ERC understand that some people interpret the FSA's text in a completely opposite fashion. It is suggested that this exemption need not be applied in relation to central counterparty exposures because such amounts are already scoped out of the definition of "exposure" for large exposure purposes; and hence the 25% limit does not apply.

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 necessarily concentrated exposures to them in a way that would constrain their use – neither for capital adequacy nor for large exposure limit purposes.

Consistent with this, the ERC notes that, in its 17 December consultation paper "Strengthening the resilience of the banking sector"<sup>3</sup>, the Basel Committee on Banking Supervision states:

- "To address the systemic risk arising from the interconnectedness of banks and other financial institutions through the derivatives markets, the Committee is supporting the efforts of the Committee on Payments and Settlement Systems to establish strong standards for central counterparties and exchanges. Banks' collateral and mark-to-market exposures to central counterparties meeting these strict criteria will qualify for a zero percent risk weight. These criteria, together with strengthened capital requirements for bilateral OTC derivative exposures, will create strong incentives for banks to move exposures to such central counterparties."

The ERC supports this approach and similarly believes that exposures to CCPs should be exempt from the 25% large exposure limit, so long as the applicable central counterparty complies with the stricter CPSS/IOSCO (and/or ESCB/CESR) recommendations for CCPs. Failure to adopt such an approach in the treatment of large exposures to CCPs would undermine the incentive effect that is otherwise being pursued.

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<sup>2</sup> <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/169.shtml>

<sup>3</sup> <http://www.bis.org/publ/bcbs164.htm>

Similarly, the ERC notes that the European Commission's 26 February consultation paper regarding further possible changes to the Capital Requirement Directive ("CRD")<sup>4</sup> makes the equivalent point:

- "Currently, banks' exposures to central counterparties (CCPs) generally attract a zero EAD; few requirements are placed on CCPs in order for banks to use a zero EAD in calculating their exposures to such entities. The Commission services will consider establishing that only institutions with counterparty collateral and mark-to-market exposures to CCPs that meet the enhanced standards as outlined above would qualify for a zero percent risk weight".

**Summary:**

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.

Accordingly the ERC supports official actions in favour of the use of robust CCPs and believes that for large exposure purposes, as for capital adequacy, there should be an appropriately sensitive treatment of CCP exposures. The ERC seeks clarification of the FSA's stance in respect of the treatment of large exposures to CCPs. In case this does not involve providing relief from the application of the 25% limit the ERC asks that the FSA reconsider its stance, in order to provide for a treatment consistent with the thrust of other ongoing official actions.

The ERC appreciate the valuable opportunity presented by the FSA's consultation paper and would like to thank the FSA for its careful consideration of the repo market oriented point made in this response. The ERC remains at your disposal to discuss any points.

Yours faithfully,



**Godfried De Vidts**

Chairman

European Repo Council

CC : ICMA European Repo Committee

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<sup>4</sup> [http://ec.europa.eu/internal\\_market/consultations/2010/crd4\\_en.htm](http://ec.europa.eu/internal_market/consultations/2010/crd4_en.htm)