



ICMA EUROPEAN REPO and COLLATERAL COUNCIL

Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Bruxelles/Brussel
Belgium

12 April 2018

Dear Sirs,

Re: European Commission targeted exploratory consultation on the finalisation of Basel III

In my capacity as the Chairman of the International Capital Market Association's (ICMA's: EU transparency register # 0223480577-59) European Repo and Collateral Council (ERCC), I am writing to draw your attention to certain concerns which the ICMA ERCC believe need careful consideration during your important work in preparation of measures for implementation in the EU of reforms to integrate the various elements of the agreed, 7 December 2017, finalised Basel III framework.

Considerations relating to haircuts:

The current consultation

The agreed, 7 December 2017, package of reforms to finalise the Basel III framework comprises several elements. Most importantly from the ICMA ERCC's perspective this, includes minimum haircut floors for non-CCP cleared SFTs, to limit pro-cyclicality of these transactions and the build-up of excessive leverage in the financial system. With respect to this, the most obviously significant paragraphs in the consultation paper are 1.10 and 1.11, which read as follows:

1.10. In the credit risk mitigation framework, the comprehensive approach for collateralised transactions has been simplified and at the same time been made more risk-sensitive and comparable across banks. In particular, the applicable supervisory haircuts have been recalibrated and the use of internal estimates (own-estimates of haircuts, value-at-risk model for certain securities financing transactions (SFTs)) has been removed. In addition, the formula for repo-style transactions covered by master netting agreements has been revised to better reflect diversification benefits.

1.11. Furthermore, the BCBS specified the treatment of certain non-centrally cleared SFTs with certain counterparties. The revised framework sets out minimum haircut floors and determines that in-scope SFTs which do not meet the haircut floors must be treated as unsecured loans.

ICMA ERCC observations relating to haircuts:

The ICMA ERCC remains unconvinced that haircut practices in the repo and collateral markets contributed materially to the financial crisis and believe that overly stringent regulation in this area might deter market participants from using these important secured forms of transactions. Evidence from the crisis (gathered by bodies such as the CGFS) made it clear that the withdrawal of funding from some weakened institutions largely took the form of the withdrawal of credit lines and certain types of collateral becoming ineligible. A mandatory through-the-cycle haircut may therefore do little to prevent pro-cyclicality in another crisis.

In support of this view we reference (i) the 2013 [paper on haircuts](#) in these markets, commissioned by the European Parliament's Economic and Monetary Affairs Committee (which concludes that the case for mandatory minimum haircuts may be flawed); (ii) an [article published by the Federal Reserve Bank of New York](#) which notes that there are systemic risks associated with the mandating of high haircuts in these markets (due to the perverse incentives they can create); and (iii) previous [shadow banking research papers](#) produced by the ICMA ERC.

Nevertheless, we believe that the intent of the international proposals for the regulation of haircuts appears broadly acceptable, although we have concerns that details of the scope and application of the proposals could still cause serious disruption to the repo and collateral markets. We believe that the focus of these rules needs to be firmly on the financing of non-prudentially regulated entities, by banks and other financial institutions subject to prudential regulation. This approach has the advantage of focusing regulatory scrutiny on the regulated sector, making implementation and supervision more straightforward, but we believe that care is needed to ensure that the rules do not drive financing activity away from regulated firms nor unnecessarily restrict the flow of financing to non-regulated firms.

In support of its stance, the ICMA ERCC wishes to highlight that if firms which are subject to prudential regulation, be they banks, investment firms, insurers or other similarly regulated financial entities, choose to conduct business with a haircut lower than suggested by risk-based models, they must then allocate appropriate risk-based capital to the transactions and this acts as an alternative brake to the build-up of leverage. We also reiterate that imposing haircuts in an inter-bank context has no net benefit for the banking system as a whole, since the effect of a haircut is to transfer risk between the parties – the effect of the haircut being the creation of protection for one party to the transaction, while at the same time creating an unsecured counterparty credit exposure impacting the other party.

Alongside taking care to clearly specify the scope of application of any new provisions to different types of counterparty, so as to suitably target their impact, detailed consideration should also be given to the creation of a workable distinction between the provision of financing (reverse repo) versus the receipt of financing. A number of new players in the market, such as corporates, have been attracted by collateralized lending. This has provided valuable new sources of funding to regulated institutions, and it would be counterproductive if the imposition of new mandatory haircut provisions deters such lending.

Accordingly, the ICMA ERCC believes that, without dropping the worthwhile effort to enhance long term financing stability through the imposition of revised and new haircut requirements, there are a number of ways in which details of the approach to be adopted could be calibrated in order to better smooth its effects on repo and collateral markets. To avoid undesirable consequences from the imposition of such requirements, the ICMA ERCC believes there should be further detailed study on the basis of detailed EU market data. The benefits of making market sensitive adaptations would ultimately be felt by borrowers, both corporate and governmental, and investors; and would help underpin the effective functioning of other regulations designed to deliver increased financial stability.

Furthermore, the ICMA ERCC fully recognises the value of broadly aligning the design of these measures with international standards. The aim should be to avoid any unnecessary fragmentation of markets, by using international standard setting to promote consistent outcomes even in case detailed rules need to accommodate relevant regional or national specificities. This then best allows the global market to represent a level playing field and creates conditions supportive of the evolution of desirable deeper and more liquid markets for repo and collateral.

The Commission's 2017 report on haircuts:

Article 29.3 of the EU's [SFT Regulation](#) (SFTR) required the Commission to submit, by 13 October 2017, "a report to the European Parliament and to the Council on progress in international efforts to mitigate the risks associated with SFTs, including the FSB recommendations for haircuts on non-centrally cleared SFTs, and on the appropriateness of those recommendations for Union markets" alongside any appropriate proposals.

On 19 October, the Commission published its duly prepared [final report](#) under SFTR article 29(3), taking into account a more detailed [report](#) previously prepared by ESMA, EBA and ESRB and issued in October 2016. The final Commission report includes a short general assessment of the functioning of SFT markets and on the impacts on leverage and options to tackle its build-up, before covering in turn the relevant FSB recommendations on SFTs and measures taken so far at EU level.

Overall, the Commission followed the guidance from ESMA and concludes that:

- To a large extent, the FSB recommendations on SFTs have been addressed in the EU through the adoption of SFTR and specific provisions in sectoral financial services legislation and guidelines. As such, there does not seem to be a need for further regulatory action at this stage.
- The Commission will continue to thoroughly monitor developments in SFT markets and the international regulatory space. The Commission will reassess the added value of qualitative standards and haircut floors on the basis of a report to be prepared by ESMA once comprehensive SFT data is available.

The ICMA ERCC notes that the process of SFTR data reporting is currently only expected to start in the second half of 2019.

On numerical haircut floors more specifically, the Commission lists the following reasons why they believe legislative action would be pre-mature:

- Lack of clarity on mutual relationship between haircuts and procyclicality;
- Discussions between ESMA and market participants as well as data suggest that haircuts actually applied by market participants tend to be higher or at the level of the haircut floors recommended by the FSB;
- SFTs in scope of the FSB recommendation (bank to non-bank and non-bank to non-bank) represent a limited share of the overall market;
- Incorporation of numerical haircut floors for bank to non-bank SFTs into the Basel III framework which was originally recommended by the FSB for the end of 2015 as a prerequisite for authorities introducing the haircut floors is still delayed; and
- Other important jurisdictions (e.g. the US and Japan) are also in the early phases of their assessments and have not taken a decision on haircut floors yet

The ICMA ERCC welcomes this Commission report and strongly endorses the view that it is appropriate to first obtain SFTR data and then to use this to appropriately design and calibrate any new EU haircut regime, whilst keeping in mind the desirability of using international standards as a broad basis for consistency of requirements across global financial markets.

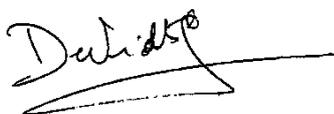
Concluding comments:

In summary:

- As outlined in Annex A, in many ways, repo and collateral markets play an important role in the financial market system.
- As highlighted in Annex B there is evidence that, notwithstanding the day-to-day functioning of these markets, there are stresses which can cause these markets to become dysfunctional.
- The ICMA ERCC fully supports the need for the EU to have in place an adequate CRR regime, including applicable haircut components; and fully recognises the value of broadly aligning this with international standards, to deliver desirable consistency across global financial markets.
- Yet it is also essential that these important requirements are designed in such a way that they do not cause unnecessary incremental friction in the well-function of repo and collateral markets.
- Details of the design need to carefully clarify the scope of application to different entity types and suitably distinguish between the provision and receipt of financing.
- Accordingly, the ICMA ERCC considers it important that market sensitive adaptations are adopted as part of any applicable further updating of the EU CRR legislative text.
- The Commission has itself already acknowledged that the design of minimum haircut requirements for application in Europe should only proceed once SFTR data can be used to suitably calibrate it.
- The benefits of carefully designing these further requirements will ultimately be felt by borrowers, both corporate and governmental, and investors; and will help underpin the effective functioning of other regulations designed to deliver increased financial stability

We politely request that you give careful consideration to the ICMA ERCC's concerns, as outlined in this response and would be happy to discuss these matters further with you.

Yours faithfully,



Godfried De Vidts

Chairman

ICMA European Repo and Collateral Council

Copy: **Mr. John Berrigan**, Deputy Director-General, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Mr. Martin Merlin, Head of Directorate D, Regulation and Prudential Supervision of Financial Institutions, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Annex A:

The Important Role of Repo and Collateral Markets

The ICMA ERCC wishes to underscore that the repo market plays a vital and central role in the modern financial ecosystem, facilitating a number of critical functions and interacting with a variety of different financial markets. Beyond providing a means for secured short-term borrowing and lending, the repo markets are essential for funding the market-making books of broker-dealers for both sovereign and corporate debt, and so play a key role in underpinning secondary market liquidity for global bond markets.

Similarly, repo markets are the glue that binds many derivatives with underlying cash securities, in particular electronically and exchange-traded bond futures and options. Liquid and efficient derivatives markets are relied upon by both financial and corporate institutions to hedge and disseminate their interest rate exposures. Often overlooked, the repo market is also where collateral is priced, sourced, and mobilised, allowing a whole range of financial and corporate institutions to meet the margining requirements that increasingly underpin today's financial markets. Finally, the repo market is the primary channel through which central banks target bank reserves and transmit monetary policy.

It soon becomes clear that the ability for the repo market to function efficiently and effectively is essential for the overall health of the capital markets through which governments and corporates raise funding and whereby investors and savers can earn returns and capital growth. In many ways, the repo market represents the foundation stone of the financial system that facilitates investment, employment, productivity, and economic growth, thus directly impacting the real economy. To interfere with the repo market is to tamper with the DNA of modern-day capital markets. Yet this is precisely what the confluence of various regulatory initiatives appears to be doing.

Annex B:

Evidence That the ICMA ERCC is Right to be Concerned

The ICMA ERCC's concerns about this have been repeatedly highlighted over recent years and the evidence that more needs to be done to rectify these concerns is continuing to build. In its short, February 2017, paper, [Closed for Business: a Post-Mortem of the European Repo Market Over the 2016 Year-end](#), the ICMA reviews the extreme volatility and market dislocation experienced in the euro repo market over the 2016 year-end, which were unprecedented in the post-euro era. This report attempts to document the market moves and behaviour in the final week of December of 2016. More specifically it seeks to answer: (i) what happened? (ii) why did it happen? and (iii) what possible measures can be taken to avoid future extreme dislocation?

The paper finds that it is reasonable to conclude that, at the end of December, the euro repo and short-term funding markets effectively broke down, something that did not happen either during the Lehman crisis or over the sovereign bond crisis. The factors driving this break-down are multiple, but a shortage of readily available HQLA as a result of quantitative easing and the reluctance, or lack of capacity, of banks to provide year-end funding liquidity are key contributors. As the ECB's bond purchase programmes are set to continue, and as more regulation puts pressure on banks' balance sheet and intermediation capacity, there is a very real concern that the market behaviour over the 2016 year-end is not a "one-off" event and could herald the start of a new normal. Indeed, the ICMA ERCC's short report on [The European Repo Market at 2017 Year-end](#) shows that the market was again expensive and difficult, albeit that the outcome was not as extreme and disorderly as the previous year.

This new state of the market heightens risks related to banks' and firms' ability to meet margin calls, which in turn could have systemic consequences. It seems unlikely that one single solution, either by regulatory or monetary policy makers, will provide a quick fix; rather it is likely to require a number of measures as well as more rigorous, ongoing analysis of the possible impacts of various policies, in order to ensure the smooth and efficient functioning of the European funding and collateral markets. Already this state of the market is making it difficult for investors to smoothly finance their requirements and is sapping the effective operation of secondary markets. These factors will in turn serve to undermine the efficiency of the primary bond market, raising financing costs for governments and businesses alike.

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.