ICMA EUROPEAN REPO COUNCIL

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

20 September 2013

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: Basel Committee on Banking Supervision consultation on its "*Revised Basel III Leverage Ratio Framework and Disclosure Requirements*"

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 the Basel Committee on Banking Supervision's (BCBS's) consultation on its "*Revised Basel III Leverage Ratio Framework and Disclosure Requirements*", as published on 26 June 2013.

Background to the ERC:

The ERC was established by ICMA in December 1999, to represent the cross-border repo market in Europe. It is composed of the vast majority of practitioners in this market, 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 twice yearly ICMA ERC General Meetings are widely attended. The appendix to this letter briefly elaborates on the significant and on-going efforts which the ERC has made to ensure the establishment of a robust infrastructure to underpin the European repo market, including through the development of the Global Master Repurchase Agreement ("GMRA").

Overall commentary:

The ERC notes that this consultation considers revisions to the simple, transparent, non-risk based leverage ratio, which has been introduced into the BCBS prudential regulatory framework for banks to act as a credible supplementary measure to the risk-based capital requirements. The overall scope of this is broader than the ERC's repo market focussed remit and accordingly the ERC looks to others to comment on the full range of questions which the consultation raises. Nevertheless, one specific and significant aspect of the consultation, namely the enhanced treatment of securities financing transactions (SFTs) falls squarely within the ERC's remit; and consequently this response submission focusses on this particular aspect.

The ERC highlights that the repo product plays a very significant role in the international securities market as a whole by providing liquidity, marketability and in offering opportunities for the mitigation of credit and liquidity risks. The results of the latest ICMA European Repo Market Survey set the baseline figure for market size at EUR 6.1 trillion.[1]

In case new regulations should precipitate a significant contraction in this important market, the ERC is concerned that there will be adverse consequences from its reduced capacity to play its various essential roles. Negative consequences in such a case would be a less liquid government bond market; less efficient transmission of monetary policy; more expensive or drastically reduced access, for both financial institutions and firms in the real economy, to the repo tool for the management of cash position; risks to financial stability as the push into collateralising financial transactions under the new regulatory framework will be undermined; and increased systemic operational risk.

In particular, the ERC wishes to highlight its concerns regarding primary dealers in government bonds. Such primary dealers facilitate government bond funding and rely on the repo market to fund their positions. Without a liquid repo market those primary dealerships will become even more uneconomical to maintain and without them government funding costs risk increasing significantly.

The ERC considers that one way in which such negative consequences are likely to be very quickly triggered is to establish a leverage ratio regime on a basis whereby appropriate counterparty netting would be prohibited for repurchase transactions and other securities financing arrangements. Such an approach would increase the capital required to maintain required leverage ratios and significantly discourage repo and securities lending activities. Hence, the ERC firmly believes that there is a need to urgently revisit the detailed language of the enhanced treatment of SFTs, in order, if at all possible at this stage, to adapt this in such a way as to mitigate the concerns which have been raised. Accordingly the ERC respectfully requests that you give this matter your close and timely attention.

The ERC’s more detailed observations are included in the following paragraphs.

General concerns:

The ERC appreciates the overall rationale underlying the proposed introduction of a uniformly calculated leverage ratio. It is understood that this is supplemental to the risk-based capital ratio, providing a backstop to limit the build-up of leverage in ways which the risk-based capital approach fails to adequately capture. The ERC understands that, as a rule, the leverage ratio is not expected to be the binding constraint, with the risk-based capital ratio normally acting to drive required capital levels. This is an important aspect, given the widely recognised concern that the leverage ratio approach serves to incentivise banks to hold higher risk assets.

Nevertheless, for this to prove to be the case details of the design and calibration of the leverage ratio naturally require careful study and attention. Furthermore, the ERC is concerned that unless the proposals are adapted it will prove to be the case that many banks find the leverage ratio to be the binding constraint. A significant factor contributing to this perceived state of affairs is the proposal that SFT exposures should be included in the leverage computation on a gross basis. The nature of banks repo activities gives rise to large amounts of repo assets and liabilities, albeit that the associated risk positions are small. The case for adoption of a net basis of computation for SFTs is elaborated in the specific points below.

[1] See the June 2013 ICMA European repo market survey at: http://www.icmagroup.org/assets/documents/Media/Press-releases-2013/ICMA1305---European-repo-market-recovers-as-banks-return-to-the-market-for-funding.pdf.

The ERC is concerned about an apparent confusion of objectives in the new proposals. No clear rationale appears to be given for the inclusion of counterparty credit risk add-ons in the calculation of SFT exposures. In the ERC's view, these amounts do not expand leverage and hence the only reason for including them would appear to be in order to indirectly tighten the leverage ratio. However, if this is the case, then this should be done by calibration of the overall minimum ratio and not by distorting the methodology. If rather, it is an attempt to engineer some other unspecified outcome, then the ERC is concerned by the subjugation of the leverage ratio, which should be used only to control leverage, to such other undisclosed purpose.

Specific points:

No appropriate counterparty netting

The ERC perceives that no compelling rationale has been advanced as to why this new BCBS proposal does not recognise appropriate counterparty netting of gross positions in the calculation of the leverage ratio. All the consultation documents says is, "This regulatory treatment is prudent and has the additional benefit of avoiding inconsistencies from netting which may arise across different accounting regimes." But of course any restriction on financial activity can be characterised as prudent. The ERC believes it is also essential to question whether the restriction is reasonable; and that there are good grounds for arguing that it is not. The leverage ratio is intended to limit the build-up of leveraged net risk positions that might have to be liquidated in a funding crisis. An intermediary does not itself take material net risk positions. If one counterparty defaults, creating an open position, the intermediary is to a large degree protected in the SFT market, unlike in the unsecured market, by the right of set-off.

The ERC considers that it is also unreasonable to argue, as the consultation paper does, that not recognising netting is necessary to avoid inconsistencies of netting under different accounting regimes. If there is no problem allowing netting in the calculation of counterparty credit risk for SFT exposures under the leverage ratio, why is there a problem for the calculation of the gross exposure? The problem of inconsistency merely requires that there is a clearly defined, specific basis upon which netting will be allowed for the purposes of the computation. This is just another example of developing a consistent regulatory accounting practice, which does not necessarily need to conform to any individual generally accepted accounting practice.

Non-recognition of netting is likely to have a material adverse impact on government financing. Over 80% of the European repo market is against government debt collateral.[2] Any contractionary pressure on repo would inevitably threaten the liquidity of that market; and the nature of the market, where short-term contracts predominate, is such that it would react very rapidly to such a pressure. That such a pressure to contract is likely is indicated by the estimate by J.P. Morgan Cazenove that the new proposal would more than double the contribution of SFTs to the leverage ratio exposure measure, to as much as 26% for some major banks.[3] If intermediary banks need to contract balance sheets in order to meet the leverage ratio, the un-weighted nature of the ratio will tend to encourage them to reduce inventories of high-volume low-risk/return assets such as government securities.

The decision not to allow repo positions to be appropriately netted off may therefore adversely constrain securities intermediation, in other words, the market-making and dealing that helps efficiently distribute government securities. The strong and clear link between repo and bond trading is easiest to demonstrate in the US Treasury market, as is illustrated in the Annexed charts.

[2] In the June 2013 ICMA European repo market survey, government bonds constituted 80.1% of EU-originated collateral.
[3] Abouhossein K et al, Global Investment Banks: Basel leverage ratio consultation: manageable, but capital at risk for Deutsche Bank and Barclays, J.P. Morgan Cazenove Global Equity Research (4 July 2013).

The ERC firmly believes that the leverage created by borrowing from and lending to the same counterparty, for the same term, under an enforceable master agreement that incorporates a robust right of set-off, is clearly only the net amount. Accordingly, as is already the case in the language of the EU Capital Requirements Regulation[4] adopted earlier this year, the ERC considers that the calculation of SFT exposures for leverage ratio purposes should take into account the effects of master netting agreements.

The ERC also particularly wishes to highlight the case of CCP cleared repo business. The process of regulatory reform has placed specific emphasis on encouraging the use of CCP clearing and separate, detailed work is being conducted by the BCBS to finalise the treatment of CCP exposures for risk-weighted capital purposes. It is important that the leverage ratio does not cut across this, through a failure to clearly recognise CCP netting.

In proposing that netting should be allowed, the ERC supports the desirability of looking through accounting standards and the actual format of the particular SFT (repo, securities lending, etc.). Instead the allowability of netting should be based on the legal enforceability of the applicable master netting agreements. This would both measure the true leverage of the system, as it would materialise in a counterparty default, and ensure that for a given level of activity the natural dynamics of the system is towards the minimum level of leverage. In such a framework an add-on based on the value at risk (VaR) of the netting set (portfolio with the same counterparty under a master netting agreement) would make sense.

The ERC considers that not allowing for appropriate counterparty netting makes the system less safe, because netting is a true risk mitigant which should be recognized and incentivised by regulation. It is widely acknowledged that total counterparty exposures should be minimised across the financial system. Achieving this implies that it is desirable to put in place nettable positions whenever possible. Not allowing for recognition of the benefit of netting means a powerful incentive to move trades to CCPs is lost. Additionally, a hedge fund counterparty with a long and short position will shop for the best repo rate with one counterparty and the best reverse repo rate with another counterparty, instead of trading the repo and reverse with the same counterparty – not allowing for netting doubles the counterparty exposure for the system in this common real life example.

Furthermore, the ERC highlights that the fallacy of not recognising netting in these circumstances is self-evident in the global double-counting that would arise under the gross approach for SFTs, given that both parties would be judged as providing leverage to each other.

Calculating counterparty credit risk as the net current exposure

The inclusion of counterparty credit risk exposure largely measures the exposures arising from giving net haircuts and lags in receiving margin. However, these exposures are credit and liquidity risks against counterparties, not leverage from those parties. It is therefore not clear to the ERC why this exposure has been added into the proposed gross leverage ratio.

Fails

The ERC sees the need for clarification as to how SFT fails are to be treated in the calculation of the leverage ratio. The ERC's presumption is that they should receive a credit conversion factor (CCF) of 10%, given that, unlike most of the other examples of commitments listed, fails in the SFT markets are not unconditional commitments.

[4] See Article 429(9) (page #253) at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF.

In repo, under the GMRA (similar rights exist in securities lending under the Global Master Securities Lending Agreement, the GMSLA), if a seller fails to deliver on the purchase date, the buyer can terminate at any time. Absent a termination, the buyer withholds the purchase price or, if he has inadvertently paid – which would be unusual, given the prevalence of settlement by delivery-versus-payment (DvP) – he should recover his money, if necessary by means of a margin call.

If the buyer in a repo fails to redeliver securities on the repurchase date, the delay maintains the existing leverage, but the seller has the unconditional right under the GMRA (and similarly under the GMSLA) to terminate the transaction by means of a mini close-out.

In the ERC's view, the consultation document appears to recognise that fails are "commitments that are unconditionally cancellable at any time by the bank without prior notice" and should therefore qualify for an exceptional CCF of 10% rather than the standard 100%. However, this is a supposition based on the fact that the reference to fails in paragraph #40 is not reflected by the inclusion of an item in the list of exposures subject to a CCF of 100% in paragraph #14 of Annex 1. Hence the ERC requests that treatment of fails be clearly confirmed.

Forward asset purchases

It has been suggested by some readers that the reference in Annex 1 to forward asset purchases encompasses the forward legs of SFTs. If this is the intention, the ERC is concerned that integrating forward transactions with no more granularity than proposed would lead to a lot of multiple counting. This would be particular punitive for activity with CCPs, where transactions for short covering are typically done on an overnight + tom/next + spot/next basis. This would prove to be three times more costly for leverage purposes than doing a single three day trade with a bi-lateral counterparty.

This does not appear to be correct in the view of the ERC, however, the ERC considers that this point needs to be clarified. The methodology of the leverage ratio basically reflects the accounting framework. Divergences from that framework are very specific and clearly identified (e.g. non-recognition of netting and credit risk mitigation, inclusion of capital investments consolidated under the risk framework but not the accounting framework, and inclusion of off-balance sheet exposures).

Under virtually all accounting regimes, SFTs involving cash are treated as financing transactions, not as current sales and future repurchases of securities. In order to treat the forward legs of repo or securities loans against cash collateral as forward asset purchases, the near legs would have to be treated as disposals. This seems to be ruled out in paragraph 36 of the consultation document.

Further points ideally in need of clarification

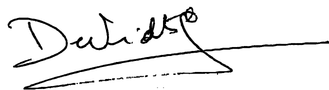
Paragraph #19 states that, "Banks must include all on-balance sheet assets in their Exposure Measure including on-balance sheet derivative collateral and collateral for securities financing transactions (SFTs) (but excluding on-balance sheet derivative and SFT assets that are covered in paragraphs 22 to 39 below)". The articulation of the distinction being made in this sentence is not clear. What types of on-balance sheet derivative and SFT collateral should be treated as falling under paragraphs #22 - #39 as opposed to being treated in on-balance sheet exposures (paragraphs #19 - #21)? Should footnote 11 in paragraph 19 be taken to suggest that the difference is fiduciary assets (held as an agent) – noting that paragraph 19 itself implies that these fiduciary assets must be included in the exposure measure, whereas footnote 11 says that exceptionally, where a national GAAP recognises such assets, they can be excluded, if they would be de-recognised at least under IAS39. The ERC requests that clarification be given to avoid any ambiguity in interpretations.

In paragraph 35(i), it is stated that the gross SFT assets should be reduced by the amount of securities received but still recognised on the balance sheet of the transferor, where the transferor could but has not given the transferee the right to "hypothecate"'. The ERC thinks that this would appear to refer to assets pledged, but without the pledgor giving a right of re-hypothecation to the pledgee. However, the ERC requests that this interpretation should be confirmed.

Concluding remarks:

The ERC appreciates the valuable contribution made by the BCBS through its examination of the issues articulated in this public consultative report and would like to thank the BCBS for its careful consideration of the points made in this response. The ERC underscores its belief that there will be serious adverse consequences if the proposed gross approach for SFTs is adopted in the leverage ratio requirements, as this would very quickly precipitate a significant contraction in this important market with consequent negative implications for government bond funding and the real economy. The ERC remains at your disposal to discuss any of the above points.

Yours faithfully,



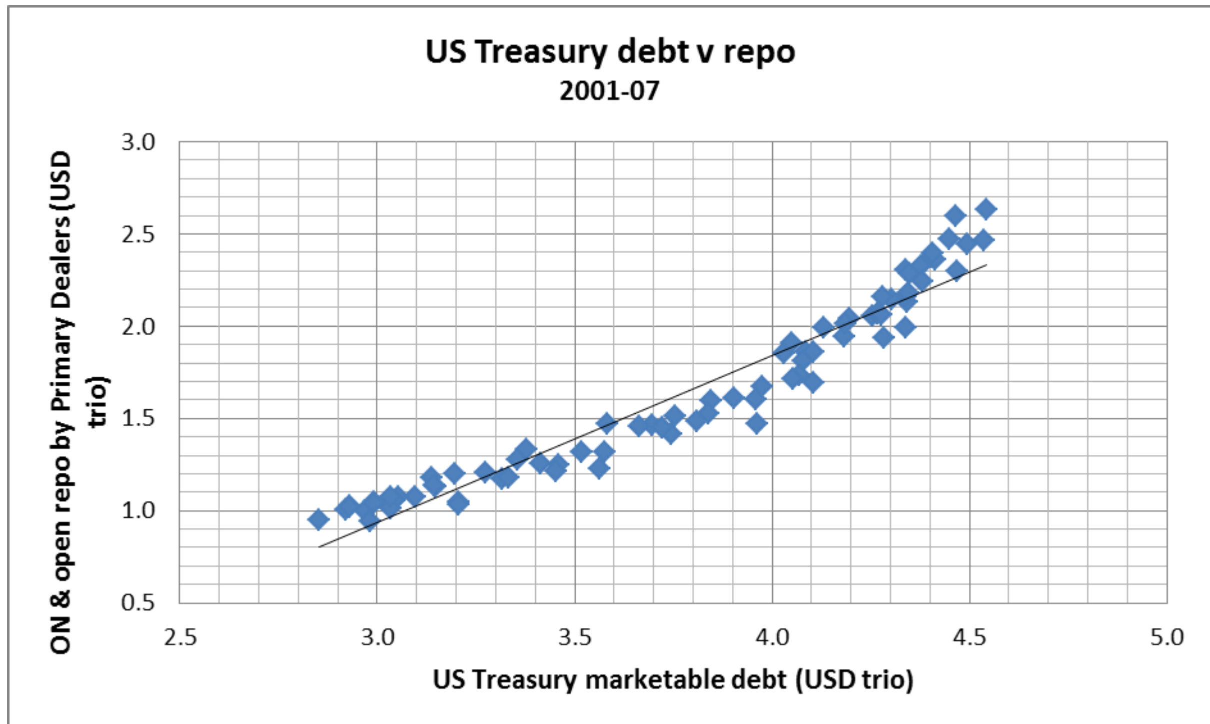
Godfried De Vidts
Chairman
ICMA European Repo Council

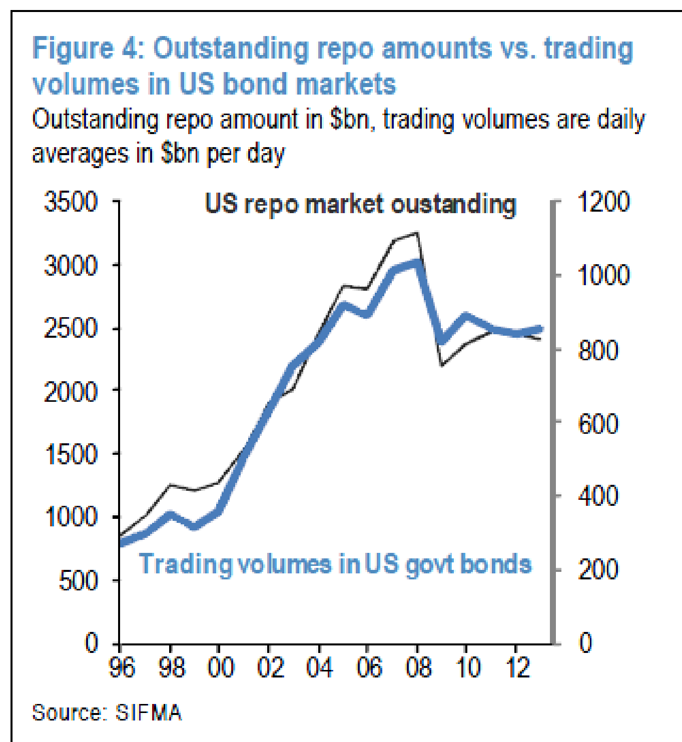
cc : ICMA European Repo Committee

Annex:

Supporting charts

The link between repo and bond trading as illustrated by the case of the US Treasury market:





Appendix:

ERC 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 ICMA European Repo Council (ERC) 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. The discussions that take place at the ICMA ERC meetings underpin the strong sense of community and common interest that characterises the professional repo market in Europe.

The ICMA ERC 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 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 standardising repo documentation. The GMRA is the most predominantly used standard master agreement for repo transactions in the cross border repo market.

Membership of the ERC is open to ICMA members who transact repo business in Europe. The ICMA ERC currently has 69 members, comprising the vast majority of firms actively involved in this market.

More information may be found in the one page article "Building and sustaining the European repo market", which appeared on page #31 in Issue 26 of ICMA Quarterly Report and through the ICMA ERC's website pages.