

EUROPEAN REPO COUNCIL

European Central Bank
Secretariat Division
Kaiserstrasse 29,
D- 60311 Frankfurt am Main
Germany

CESR
Victoria Powell,
Director for Communication and Common
Supervisory Culture,
11-13 avenue de Friedland,
75008 Paris
France

London, January 23, 2009

Dear Sir, Madam,

The European Repo Council (ERC) was established by the International Capital Market Association (ICMA) in December 1999 to represent the EUR 7 trillion repo community in Europe.

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.

The ERC welcomes the opportunity to respond to the CESR/ESCB consultation paper, and supports the main aim of the Recommendations: to promote competitive, efficient, safe and sound pan-European post trading arrangements.

The following comments are specific to the repo market and address different key points or explanatory memoranda of each Recommendation. The ERC response aims at promoting a safe, efficient, but also transparent European clearing and settlement system.

The ERC considers the ESCB/CESR Recommendations as a necessary complement of other lines of work, such as the Code of Conduct on clearing and settlement and the CESAME (I and II) work on removing the Giovannini Barriers.

The ERC remains at your disposal to discuss any of the points raised in its response,

Yours sincerely,



Godfried De Vidts,
Chairman
European Repo Council

Part 1: Draft recommendation for securities settlement systems

Recommendation 1: Legal Framework

Securities settlement systems, links between them or interoperable systems should have a well-founded, clear and transparent legal basis for their operations in the relevant jurisdictions

The ERC supports this recommendation. The Recommendation complements the GMRA, a *de facto* standard for documenting repo and buy-sell back transactions in the international financial markets. The GMRA is widely accepted as the market standard agreement in a number of markets, particularly on a cross-border basis. As well as the basic terms for repo transactions, the GMRA contains important provisions which are aimed at reducing risk for users of the agreement. These include the ability for either party to call for margin at any time (on an intra-day as well as daily basis) and comprehensive default and close-out and netting provisions which enable a non-defaulting party to take early action to protect itself in the event of the insolvency or other default of its counterparty. Although governed by English law, ICMA has obtained legal opinions in 68 jurisdictions which confirm the enforceability of the GMRA, both generally and in insolvency.

Recommendation 2: Trade confirmation and settlement matching.

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferable on T+0, but no later than T+1.

Settlement instructions should be matched as soon as possible and, for settlement cycles that extend beyond T+0, this should occur no later than the day before the specified settlement date.

The ERC's concern relates to the settlement instructions of this Recommendation. These should be matched no later than the trade date (T+0) or no later than T+1 in special cases. Anything beyond T+1 creates additional risk. As an example, if you have the wrong counterparty on the books for an outright trade that kicks in 6 months from the trade date you should not have to wait the day prior to settlement to confirm as the involved replacement risk will be huge. The Lehman case showed this is not acceptable.

Key point 3: The use of electronic trading systems is well established in repo markets and should be further encouraged as it would automatically improve settlement towards T+0 for all financing trades. It would also reduce counterparty settlement risk for non-central counterparty cleared trades. Open access to all clearing and settlement venues will avoid inefficiency and market fragmentation while enhancing interoperability. The ERC Operations group – a sub-group of the ERC working on technical issues – and the EPDA are currently working on post-trading facilities and the identification of barriers to post-trading (for repo and bonds). The work has been commissioned by the European Commission and will be presented at the next CESAME 2 meeting scheduled for February.

Recommendation 3: Settlement cycles and operating times

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of EU-wide settlement cycles shorter than T+3 should be evaluated.

The operating hours and days of CSDs should be open at least during the operating time of the relevant payment system (at least during TARGET2 operating times for transactions denominated in euro).

Point C.11.: The ERC has always worked towards avoiding of settlement failures, but recognises that due to some technical issues this cannot be avoided at times. The improvements in settlement cycles as envisaged through the work on Giovannini Barriers 2 and 10 by the ERC Operations Group with the EPDA and on Barriers 4 and 7 by the ESSF and ESCDA in the Cesame 2 framework and the enhanced use of electronic trading as mentioned in our comments as regards Recommendation 2, would produce great improvements in the settlement of trades and decrease possible failures of settlement.

In the case of market abuse, in particular in a negative interest rate environment, the ERC has put a recommendation in place to avoid any long term disruption due to fails¹. It is therefore considered contra-productive to introduce fines for failed trades as this penalty does not remove the specific cause of failure. The US Treasury Market Practices Group announced on January 6, 2009 that fines will be introduced for failed trades in the repurchase market. The ERC monitors the situation very carefully in Europe and may intervene at short notice if market abuse would occur (through consultation with the regulators and publically if needed).

The legal framework for repo under the Global Master Rate Agreement (GMRA) as promoted by ICMA stipulates rules and recommendations for failure of delivery of any trades. ICMA's secondary market rule book provides the framework for the close out of trades between counterparties either for a specific trade or for the default of a counterparty. As such the ERC sees no need to introduce additional legislation for settlement failures as suggested in this paragraph.

. As regards the proposal of setting up a maximum size for settlement instructions, from a users' point of view, it makes no sense to limit the maximum size. The wider adoption of electronic trading would mean that bigger size transactions would be automatically transmitted to the CCP. The CCP will in turn net down these transactions using the 'shaping' practice for settlement. Therefore pushing for maximum size settlement in an electronic environment complicates unnecessarily settlement processes with no tangible benefit. A careful balance has to be struck to avoid multiple trades for the same underlying transaction as this would overburden settlement engines, particularly for bilateral trades.

¹ The ERC issued a recommendation on negative interest rate transactions available at <http://www.icmagroup.org/ICMAGroup/files/de/de274c96-6e44-4211-bed5-00d7340a13e2.pdf>

Recommendation 4: Central counterparties (CCPs)

The benefits and costs of establishing a CCP should be evaluated. Where a CCP mechanism or guarantee arrangement has been introduced, it should be assessed against the ESCB-CESR Recommendations pertaining to CCPs or against the checklist for guarantee arrangements respectively.

Point C.6.: There is potential confusion in this paragraph between a true CCP and the arrangements described in parts 1 and 2 of this consultation. An exchange or CSD cannot be compared to a CCP. Indemnifying market participants against losses from counterparty defaults may create the false illusion of protection to the users. The ERC recommends this paragraph to be redrafted to clarify the bilateral nature of arrangements in place. In addition the paragraph should clearly mention that, although these bilateral arrangements present similarities to the function of a CCP, they stand in no case for a true CCP function.

Recommendation 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for avoiding settlement failures and expediting the settlement of securities. Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.

The ERC welcomes this Recommendation as the security lending method provides additional collateral transfer. This also allows the smoothing out of settlement of securities, a result that is recommended by the ERC.

Recommendation 6: Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest possible extent. To safeguard the integrity of securities issues and the interests of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner.

Key point 3: As mentioned under this key point, the ERC is of the view that CSD activities necessitate separating the CCP services into a distinct legal entity. In case a CSD or CCP own a trading platform for equities, fixed income or derivatives each layer of activities should be a separated function. This would provide unrestricted access of all counterparties (individual firms or MTFs) without blurring the lines of the various activities. The ERC in this context regards the Code of Conduct on Clearing and Settlement and the results achieved as regards price transparency. The ERC looks forward to further progress in the cases of interoperability and accounting separation. The ERC is actively involved in the Monitoring Group (MOG) of the Code of Conduct.

Recommendation 7: Delivery versus payment (DVP)

Principal risk should be eliminated by linking securities transfers to fund transfers in a way that achieves delivery against payment.

Key point 2: The ERC recommends that this paragraph is expanded stating that securities transactions against cash between CSDs should also be settled on a DVP basis. Only at the specific request of the user a deviation from this practice could be acceptable, on an exceptional basis only.

Recommendation 8: Timing and settlement finality

Intraday settlement finality should be provided through real-time and/or multiple-batch processing in order to reduce risks and allow effective settlement across systems.

Point C.1.: The timing of settlement finality is crucial for orderly settlement of all transactions, specifically those in the same currency. National legislation should be harmonised throughout a currency union (Euro specifically in this case) as identified in the Giovannini report barrier 2². Unequal timing creates systemic risk and should without any further delay be changed into a unique European settlement platform (real time).

Point C.8: The ERC is of the view that “a significant number of batches during the day” should be tightened in respect of two areas. This point should ensure that a) it covers the same timing throughout the settlement cycles in one single currency zone by all CDS and CCPs and 2) batches are processed within a certain timeframe (example every 30 minutes maximum but gradually moving to full real time). This would greatly reduce inefficiencies and come close to a real time settlement system up to when the final solution is in place.

Recommendation 9: CSD risk controls to address participants’ failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, as a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

The ERC agrees that in the case of CSDs extending intraday credit to participants appropriate risk controls should be put in place. Moreover the ERC is of the view that participants should be made aware of procedures implemented so to better understand CSDs’ risk management policies.

² National clearing and settlement restrictions that require the use of multiple systems.

Recommendation 10: Cash settlement assets

Assets used to settle payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the system from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Point C.6: The provision of settlement facilities in both central bank money and commercial bank money should be granted equally to all participants. Clarification of “all participants” would be useful i.e. CCPs, MTFs, individual counterparties. The benefit of the ESCB/CESR recommendations can only be maximized when all users have access to CSD facilities. This would further improve developments towards electronic trading by the use of STP in a T+0 environment for all instruments, and allow better and more extensive use of the existing exchange and OTC market infrastructures.

Recommendation 11: Operational Risk

Sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed. This risk should be minimized through the development of appropriate systems and effective controls and procedures. Systems and related functions should (i) be reliable and secure, (ii) be based on sound technical solutions, (iii) be developed and maintained in accordance with proven procedures, (iv) have adequate, scalable capacity, (v) have appropriate business continuity and disaster recovery plans that allow for the timely recovery of operations and (vi) be subject to frequent and independent audits.

The ERC agrees with this recommendation

Recommendation 12: protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of the creditors of all entities involved in the custody chain.

The Lehman case and the fact that the liquidator blocked bonds owned by hedge funds are telling. Bonds used as collateral because of lack of segregation of accounts shows the possible impact of this Recommendation in the wider market. However the GMRA gives full protection to liquidate holding and as such this situation did not occur in the repo market.

Recommendation 13: Governance

Governance arrangements for CSDs should be designed to fulfill public interest requirements and to promote the objectives of owners and market participants.

The ERC welcomes this recommendation

Recommendation 14: Access

CSDs should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

The ERC welcomes this Recommendation. This Recommendation should equally be applicable to CCPs as users being individual clients or MTFs would benefit from electronic trading platform facilities in an individual or industry organized way. Many market infrastructures have been tested in the current financial market turmoil showing operational efficiencies. To further develop current market infrastructures would reduce operational, contingent credit and market risks. Unrestricted access to both CSDs and CCPs would additionally increase auditability and processing capacity of existing market infrastructures, materially reduce costs and improve the operating performance and return on capital of users.

Key point 2: Access to all participants should be clearly identified on the website of each provider by each CSD or CCP. Denial of access should indeed be explained in writing but a specific deadline of response is advisable to avoid unnecessary delays for potential participants.

Recommendation 15: Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

The ERC welcomes this Recommendation.

Recommendation 16: Communication procedures, messaging standards and straight-through processing (STP).

CSDs and participants in their systems, should use or accommodate the relevant international communication procedures and standards for messaging and reference data in order to facilitate efficient clearing and settlement across systems. This will promote straight-through processing (STP) across the entire securities transaction flow.

The ERC supports this recommendation.

Recommendation 17: Transparency

CSDs should provide market participants with sufficient information for them to identify and accurately evaluate the risks and costs associated with securities clearing and settlement services.

The ERC supports this recommendation. The ERC reiterates the importance of the Code of Conduct on Clearing and Settlement and its attached Monitoring group.

Recommendation 18: Regulation, Supervision and Oversight

CSDs and securities settlement systems should be subject to transparency, consistent and effective regulation, supervision and oversight. In both a national and a cross-border context, central banks and securities regulators should cooperate with each other and with other relevant authorities regarding the CSD and the securities settlement systems it operates. Central banks and securities regulators should also ensure a consistent implementation of the recommendations

The ERC welcomes this Recommendation.

Recommendation 19: Risks in cross-system links or interoperable systems

CSDs that establish links to settle cross-system trades should design and operate such links so that they effectively reduce the risks associated with cross-system settlements. They should evaluate and mitigate the potential sources of risks that can arise from the linked CSDs and from the link itself.

The ERC welcomes this Recommendation.

Part 2: Draft recommendations for central counterparties

The European Repo Council has positively welcomed the development of CCPs in Europe. Through various advisory group meetings ERC members have been able to develop a product range that provides a safe environment allowing netting of outstanding trades (balance sheet relief) but also a reduction of counterparty risk. In this context, the ERC would highly recommend careful consideration to the debate regarding further development of this crucial market infrastructure. Recent market developments should not increase risks. Competing CCPs may leave aside the strictest risk management techniques to benefit their commercial interests.

In the European context restrictions remain in place for some participants to certain CCPs. Protectionism by CCPs benefiting trading platforms from their group are noticeable. The current work of the ERC Operations Group and EPDA, referred to in the case of some part I Recommendations, will be valuable to assess in which markets post-trading barriers still exist. The follow-up report expected to be presented at the February Cesame 2 meeting will provide a sound basis to tackle these Barriers. In the Monitoring Group (MOG) established by the EU Commission issues have been identified for equity venues. Similar practices exist in the fixed income area. It is therefore crucial that requirements are clearly stated and publicly disclosed avoiding discrimination against classes of participants (individual or MTF's). Without free access for all users the maximum benefit of a CCP will never be achieved, competition should be on pricing and service levels, not on risk management. The Code of Conduct on Clearing and Settlement encapsulates such an endeavour. Phase I of the implementation of the Code of

Conduct directly deals with price transparency. This phase is hoped to allow users to compare different platforms on price and services offer. The ERC sees the recommendations for CCPs as crucial to the future development of the European financial market industry.

Recommendation 1: Legal Risk

CCPs, linked or interoperable CCPs should have a well –founded, transparent and enforceable legal framework for each aspect of their activities in all relevant jurisdictions.

The ERC agrees with this Recommendation.

Recommendation 2: Participants requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on a ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

Key Point 2: The section of this paragraph regarding the possibility of an applicant to question the refusal of access, and for the latter to be subjected to a third-party review requires further elaboration. This section begs the questions of who will conduct third-party review. National authorities often are biased towards national champions; a European wide party would protect market participants against biased competition guarantying equal access to the use of the products on offer. Equal use should have an equal price, anti-competitive measures from the provider, should be avoided.

Recommendation 3: Measurement and Management of Credit Exposures

A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements and other risk control mechanisms, a CCP should limit its exposures to potential losses from defaults by its participants so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

The ERC endorses this Recommendation. However the ERC understands that each participating firm (for all the products used with this CCP) needs to be concerned with the losses of defaulting counterparties.

Recommendation 4: Margin requirements

A CCP should to the greatest extent feasible impose margin requirements to limit its credit exposures to participants. These requirements should be sufficient to cover potential exposures that the CCP estimates to occur until the liquidation of the relevant positions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

The ERC does not have any comment as regards this Recommendation.

Recommendation 5: Other risk controls

A CCP should maintain sufficient available financial resources to cover potential losses that exceed the losses to be covered by margin requirements. For this purpose, the CCP should develop plausible scenarios and conduct stress tests accordingly. At a minimum, a CCP should be able to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

The ERC agrees with this Recommendation.

Recommendation 6: Default procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available and tested regularly.

The ERC agrees with this Recommendation.

Recommendation 7: Custody and investment risks

A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimized. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

The ERC agrees with this Recommendation.

Recommendation 8: Operational Risk

A CCP should identify sources of operational risk, monitor and regulatory assess them. The CCP should minimise these risks through the development of appropriate systems, and effective controls and procedures. Systems and related functions should be (i) reliable and secure, (ii) based on sound technical solutions, (iii) developed and maintained in accordance with proven procedures and (iv) have adequate, scalable capacity. The CCP should have appropriate business continuity and disaster recovery plans that allow for timely recovery of operations and fulfillment of a CCP's obligations. Systems should be subject to frequent and independent audits.

The ERC agrees with this Recommendation.

Recommendation 9: Money settlements

A CCP should employ money settlement arrangements that eliminate or strictly limit credit and liquidity risks. If central bank money is not used, steps must be taken to strictly limit cash settlement risks, that is credit and liquidity risks stemming from the use of banks by a CCP to effect money settlements with its participants. Fund transfers to a CCP should be final when effected and rely on efficient and safe payment systems.

The ERC agrees with this Recommendation.

Recommendation 10: Physical deliveries

A CCP should clearly state its obligation with respect to physical deliveries. The risks from these obligations should be identified and managed.

The ERC agrees with this Recommendation.

Recommendation 11: Risks in links between CCPs

CCPs that establish links either cross-border or domestically to clear trades should design and operate such links so that they effectively reduce the risks associated with the link. It should evaluate the potential sources of risks that can arise from the linked CCP and from the link itself. It should ensure that the risks are managed prudently on an ongoing basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.

Key Point 7: In light of the unwinding of Lehman last September, particular attention should be paid to the unwinding by each CCP in Europe. These findings should be studied and compared by the regulators in order to evaluate the potential risks in links between CCPs. The potential biggest risk for market participants is the scaling down of risk assessment by each CCP due to competition between these types of providers, a risk that should be avoided at all cost.

Recommendation 12: Efficiency

While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

The ERC agrees with this Recommendation.

Recommendation 13: Governance

Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

The ERC agrees with this Recommendation.

Recommendation 14: Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

The ERC agrees with this Recommendation.