SECURITIES LENDING AND REPO COMMITTEE

Tuesday 8 March 2011

Bank of England

MINUTES

Attendees

Chris Salmon	Bank of England, Chairman
James Purchase	Bank of England, Secretary
Simon Debbage	Bank of England
Matthew Dive	Bank of England
Andrew Grice	Bank of England
Ronan Hodge	Bank of England
Graham Young	Bank of England
Peter Zimmerman	Bank of England
John Hale	ABI
Stephen Burton	AFME
Andre de Roy	APACS
Will Duff-Gordon	Data Explorers
Antony Baldwin	ERC
Rob Fair	Euroclear
Heather Pilley	Financial Services Authority
Rupert Macey-Dare	Freshfields
Geoff Heaton	HM R&C
David Hiscock	ICMA
Guy Sears	IMA
Kevin McNulty	ISLA
Richard Thompson	ISLA
Nigel Bradley	LCH.Clearnet
Jamie Smith	Lloyds Banking Group
Ian Fox	LMMA
John Tanner	London Stock Exchange
Joyce Martindale	NAPF
David Hopton	Santander

Introductions

Chris Salmon (Bank) welcomed **James Purchase (Bank)** as new secretary to the committee. Apologies had been received from **Godfried de Vidts (ICAP)**, **Liz Murrall (IMA)**, **Hugh Gibson (ISLA)**, **Julian Le Fanu (NAPF)** and **Dagma Banton (LSE)**.

1 Minutes of the previous meeting

The minutes of the previous meeting were agreed.

2 Matters Arising

There were no matters arising as all items were picked up in the agenda.

4 Market developments

i) Update on market conditions

Repo

Mr Baldwin reported an increase in EONIA volatility in January, although specific reasons remained unclear. The temporary spike in the ECB standing facility to £15.7bn in February created some market uncertainty and led to increased volatility of specials. However, this was soon reported to have been a temporary phenomenon and specials volatility returned to normal levels.

Repo volumes had been strong with an increase in short-dated repo trades on one major electronic platform from £188bn (in Nov 2010) to £205 billion. There continued to be significant interest in Spanish bonds cleared through the LCH, with demand particularly notable in terms from 1 month to 1 year.

The RONIA (repurchase overnight index average) project was in the final stages and completion was expected later this year.

An increase in volume for 5-year term collateral upgrade trades had been seen and commented on by a number of dealers. These had generally been collateral upgrade trades in which non-government collateral was placed to insurance companies in return for government bonds under securities lending documentation. **Mr Smith** thought that demand was seen to be driven by insurers rather than by banks, with no transactions driven by agent lenders. **Mr McNulty** indicated that he was aware of these developments and that ISLA would continue to monitor and research the development of term collateral upgrade trades.

Mr Hopton noted that a relatively new development for the sterling market had been increased volume in forward dated repo trades. This was seen as partially driven by the new liquidity regulations.

Mr Baldwin noted that the ICMA Repo survey results were due to be published on Thursday 10th March.

Securities lending

Mr Thompson noted ongoing demand for German government bonds and gilts out to 10 years, although more broadly, demand for fixed income assets was still lower than that seen in previous years. In equities, loan balances had receded somewhat due to profit taking by hedge funds towards end-2010 and rallied slightly since the start of the year. Generally hedge funds continued to have a net long bias, which meant that demand for equity securities lending was still depressed relative to prior years.

Mr Duff-Gordon noted that demand was still weak with supply outweighing demand by a factor of 8-12 times. Risk was still the main concern, but a secondary concern was tension over income, which could come to the fore when risk concerns began to recede.

Pension protection funds had reportedly started securities lending.

5 CCP Discussion Paper

Mr Dive provided the committee with a presentation on the potential benefits to the securities lending market of central counterparty (CCP) clearing. The presentation drew upon a note that was prepared for the committee[1]. Committee members were invited to comment on whether CCP clearing could help mitigate key risks in securities lending markets; costs or risks to CCP clearing; whether there are barriers to adopting CCP clearing and how these barriers

[1] See: 'CCP Clearing for Securities Lending Markets', available at: http://www.bankofengland.co.uk/markets/gilts/ccpcslm.pdf

might be overcome; and whether there are other important risk factors which are not addressed by CCP clearing.

CCPs were thought to help facilitate more conservative and transparent margining practises, as hypothesised by the Bank of England note, but it was suggested that beneficial owners, for whom lending was an optional activity, could choose to withdraw from the market if lenders were margined. Committee members noted that whilst greater transparency would benefit the industry, transparency is already offered to some extent through data aggregators.

It was also noted that CCPs are potentially more capital efficient. A securities lending transaction via a CCP carries a 0% risk weight, compared to 20% on a bilateral arrangement with a bank and 100% with a pension fund.

It was thought important to consider whether a CCP clearing system would be able to process transactions on an anonymous platform or bilaterally, or a combination of the two. It was also noted that while the CCP's credit intermediation function allows participants to trade anonymously, such anonymity is not always preferable with securities lending. Furthermore, multiple CCPs would be needed to cover the range of markets in which securities lending activity takes place requiring contributions to multiple default funds by lenders.

Some SLRC members considered that adverse consequences arising from the implementation of CCPs in the near term could be a risk. Those members thought it better to allow them to find an appropriate place in the market in the medium – long term.

Committee members highlighted some potential concerns about the use of CCPs. One was that a CCP further lengthened the long chain of intermediaries involved in securities lending. This was a concern for beneficial owners who preferred to be 'closer' to their securities. **Mr Young** pointed out that while this was the case, CCPs did act as a firebreak against failures further down the chain. Moreover, properly segregated accounts could allow owners to be at least partially insulated from the failure of their agent or clearing member.

Another concern was that while CCP clearing mitigates counterparty credit risk, it could amplify cash reinvestment risks, or if CCPs reinvested cash only in high quality government bond repo that could drain liquidity from other repo markets.

In closing, **Mr Salmon** agreed that CCPs were unlikely to solve all problems in the securities lending market, and emphasised that the Bank does not expect them to do so. Nevertheless, they may provide benefits which justify greater use. More investigation into the pros and cons of CCP clearing was appropriate and a discussion at a later SLRC meeting might be warranted.

6 CPSS Report: Strengthening repo clearing and settlement arrangements

Mr Debbage updated the committee on a September 2010 BIS paper on repo clearing and settlement arrangements. The full report can be found at: http://www.bis.org/publ/cpss91.htm. The discussion focussed on eight issues raised by the paper, with a particular focus on credit risk and CCPs, market transparency and collateral liquidation. It was emphasised that the aim of the discussion was not to mandate action but to reflect on how existing arrangements performed during the crisis and how these might potentially be improved going forward.

Mr Hiscock welcomed efforts to improve repo market infrastructure. While improvements could not be expected to solve all problems, it was thought likely to have a marked positive impact. He referenced a white paper (July 2010) by ICMA which addresses the need for reform of European repo market infrastructure[2]. This paper was updated in December 2010 and again in March 2011.

Mr Tanner noted that developments on collateral liquidation would be particularly welcome. The BIS paper suggested CCP usage, concentration limits and new infrastructure as possible measures to mitigate the risk of fire sale arising from the default of a cash borrower.

7 Regulatory developments relevant to securities lending and repo markets

i) FSA update

Ms Pilley updated the committee on recent regulatory developments in which the FSA was involved. These included an update on the short-selling regulation, which is expected to be enacted between Easter and the summer; the European Market Infrastructure Regulation (EMIR) for clearing and reporting of OTC derivatives, also expected with similar timing; the MiFID and MAD legislative proposals, anticipated for May/June; EU developments on close-out netting; and the new UK resolution framework for investment banks.

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[2] European repo market white paper (ICMA): http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx.

The new UK resolution regime for investment banks – the Investment Bank Special Administration Regulations 2011 – will appoint an administrator to address the return of client assets and to work with markets to deal with failed trades.

The EU work on close-out netting, which forms part of a larger piece of work on resolution, aims to facilitate the resolution of a failing bank which has outstanding transactions subject to close-out netting contracts. One option being considered is to allow resolution authorities, on an EU-wide basis, to impose a 24-48hr moratorium on the exercise of counterparties' close-out rights. Its rationale is mainly to provide authorities with additional time to consider the transfer of relevant contracts as part of a resolution measure.

Mr Hiscock raised the ICMA's concern that MiFID proposals on "organised trading venues" appear to include money market instruments, and noted the ERC's concern that CSD regulation and harmonisation of securities settlement might damage commercial bank settlement processes. He also drew attention to the ERC's response the EU consultation on resolution, highlighting how new close-out netting rules will interact with existing netting rights. **Mr Sears** noted that the US Dodd Frank Act will have a 24hr moratorium.

8 SLRC Subcommittees

i) Securities Borrowing and Lending Code

Hugh Gibson had sent apologies and was not available to update the committee on the work of this sub-committee.

ii) Education and Documentation

Ms Martindale updated the committee on the distribution of the introduction to securities lending publications produced by the sub-committee. She noted they had been publicised at recent events and they were combining the distribution effort with other guides for pension funds, e.g. a guide to hedge funds and how they could be used as part of an investment strategy. **Mr Salmon** asked for an update on progress at the September SLRC meeting.

ii) Netting

Mr McNulty reported that the annual opinions exercise was almost complete and that the new ICMA GMRA was on schedule to be completed by the end of March. Croatia and

Mexico would be added as counterparties. Work was being done to address the issue of subscription fee arrears. The sub-committee would be writing to several firms to chase up payments which had fallen into arrears.

9 Work Programme Updates

i) ISLA Update

Mr McNulty reported that the ISLA work programme was dominated by regulatory items; namely Solvency II and EC short selling regulations. On the latter, there were some concerns that the current drafting of the short selling legislation might encompass securities lending activity despite assurances from the EC that it would not.

ii) ERC Update

Mr Hiscock and **Mr Baldwin** reported that the GMRA was being finalised and that the ICMA-ERC semi-annual survey of the European repo market was due to be released in March. The survey was based on returns from 55 financial institutions in Europe and showed a year-on-year increase of 6% in European repo market activity. It also showed that 70% of business was not cleared by a CCP.

10 Any other business

Term DBV

Mr Grice flagged that the Bank of England would like to understand the likely take-up by the securities lending community of term DBV products.

Work programme 2011/2012

Mr Salmon asked committee members to submit proposals for new SLRC work programme ahead of the June SLRC meeting.

Change of SLRC Chair

Mr Salmon announced that he would become Executive Director of Banking Services and Chief Cashier at the Bank of England with effect from 1 April. A new SLRC Chair would take over the role from the June SLRC meeting.

Next Meeting

The next SLRC meeting is due to be held at the Bank of England on Tuesday 14 June 2011.