

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

EBF input for Commission delegated act on the leverage ratio

Introduction

On 10 March the European Commission hosted a public hearing regarding the leverage ratio, in which the European Banking Federation (EBF) participated.

From the public hearing the EBF understands that the Commission intends to finalise the delegated act in article 456.1(j) of the CRR - that grants the Commission the right to amend the capital measure and the total exposure measure of the leverage ratio referred to in Article 429 (2) of the CRR - before 30 June 2014. The EBF furthermore understands that the reason for this timeline is to allow for the Commission to take possible changes of the leverage ratio definition at level 1 into account in the final design of the ITS on disclosure requirements for the leverage ratio - which enters into force on 1 January 2015 - and for the ITS on supervisory reporting of the leverage ratio. The Commission has given stakeholders until 31 March 2014 to submit written contributions to this effect.

The EBF welcomes the possibility for stakeholders to provide the Commission with further input on the leverage ratio as a follow-up to the public hearing. The EBF however does not believe that there is any need to rush to complete the CRR leverage ratio definition by delegated act. There are currently more than ten pages of industry FAQs¹ to the Basel III leverage ratio of January 2014 (BCBS 270) which the EBF expects will result in some clarification and revisions to the architecture of the Basel III leverage ratio. Finalising the delegated act ahead of such changes will damage the overarching objective of international consistency. The EBF therefore recommends that the delegated act is postponed until the Basel III leverage framework can be considered completely stabilised.

In this document the EBF puts forward its comments on the CRR delegated act on the leverage ratio definition. These comments are especially important, as the scope of application of the

¹ http://www.futuresindustry.org/downloads/BCBS_LR_FAQ_cover_letter.pdf

leverage ratio is wider in Europe, as it pertains to all banks active in the EEA instead of only internationally active ones that are in the scope of the BCBS.

The EBF comments are divided in two parts. In *the first part* the EBF makes some general comments on the conclusions of the Commission to align the CRR leverage ratio exposure measure with the Basel III leverage ratio exposure measure. In *the second part* the EBF addresses the questions posed by the Commission in its stakeholder paper, especially as regards the treatment of SFTs, written credit derivatives and derivatives collateral.

1. General comments

The Commission stakeholder paper² states that the *EBA report on the impact of differences in the leverage ratio definitions*³ recommends aligning the CRR to the Basel III leverage ratio of January 2014⁴ in terms of the definition of the leverage ratio exposure measure. Moreover, it states that the EBA report emphasizes that the analysis underlying the EBA report has not indicated any EU specificities which would lead to recommending a divergence from the Basel rules text.

The EBF supports the intention of the Basel Committee to introduce an internationally uniform and consistent definition of the leverage ratio as a simple back stop measure that complements the risk-based capital framework for banks.

With the aim of obtaining a more internationally uniform regulation that guarantees a "level playing field", the EBF would welcome some changes to the CRR leverage ratio that could be applied before analysing reporting evidence, without undue risk, such as:

- Calculation of the Leverage Ratio shall use end quarter numbers;
- Scope of consolidation shall be the regulatory scope of consolidation;
- Using the credit risk conversion factors for off-balance sheet exposures (0%, 20%, 50%, or 100% depending on the risk category), but subject to a floor of 10%.

This being said, the EBF has some specific concerns regarding some of the recommendations of the EBA report, which are addressed in the following points:

- The impact of the leverage ratio as defined in CRR article 429 (2) - which is different from the Basel III leverage ratio on certain parameters - has not yet been tested on banks, due to the delay of the adoption of the ITS on reporting of the CRR leverage ratio. This delay in effect means that banks will be able to comply with the reporting ITS at the earliest by June 2014. The CRR article 456.1(j) empowers the Commission to amend the LR calculation *if the reporting requirements demonstrate any shortcomings*. Viewed to

² http://ec.europa.eu/internal_market/conferences/2014/0310-lcr-lr-hearing/docs/stakeholder-paper_en.pdf

³ <http://www.eba.europa.eu/documents/10180/534414/EBA+-+Leverage+ratio+analytical+report.pdf>

⁴ <http://www.bis.org/publ/bcbs270.pdf>

the delay in the reporting ITS, it will hence not be possible to demonstrate any shortcomings based on reporting before the Commission's deadline for amending the delegated act, e.g. 30 June 2014. Therefore, **the EBF finds it premature to conclude that there is a need to change the composition of the CRR leverage ratio and align it to the Basel standard for SFTs and derivatives.** The CRR pre-views a report (CRR article 511) that, on the basis of the reporting, will analyse the composition of the leverage ratio, its impact and its possible final calibration by EBA in October 2016. EBF believes that any conclusions of the adequacy of the CRR leverage ratio definition should await this analysis.

- The **absence of consistent data** on the impact of the Basel leverage ratio is clearly demonstrated in the EBA report on the leverage ratio. The EBA report based its analysis on data gathered for Basel III monitoring up to June 2013 recognising that "*The CRR definition of the leverage ratio and the Basel III definition have not yet been tested through a quantitative impact study (QIS), which implies that the corresponding estimations are based on a number of simplifying assumptions as the available data did not always allow for an assessment with full precision*". Despite this lack of quantitative impact assessment the EBA recommends the alignment of the CRR to the Basel leverage ratio definition for the benefit of consistency with leverage ratio calculation within the EU and the other jurisdictions.
- The EBF has received indication from European banks that an alignment to the Basel definition regarding the treatment of SFTs and derivatives will cause a significant increase of the total exposure measure (the denominator in the leverage ratio definition). Therefore, the EBF believes that EBA's statement, that there is not a significant increase, is based on the lack of the quantitative assessment from EBA.
- It should be noted that the EBA report claims that the CRR may allow for different interpretations of the treatment of SFTs which could lead to a discrepancy in the level of the Leverage ratio, and hence EBA suggests full alignment with the Basel III framework. The EBF believes that there is a need for clarification of the CRR articles 429(5) and 429(9). Paragraph 5 states that the leverage ratio is based on accounting exposures, whenever another methodology is not specified. Paragraph 9 introduces such methodology for SFTs, by allowing netting under various conditions stated in articles 220, 222 and 206. Netting is retreatment of accounting entries, not a provision for taking into account a new risk not considered in accountancy. It is not an add-on mechanism, aiming to encompass for example, the future volatility of accounting figures. **So, in the EBF's view interpretation 1 must prevail: the net figures are a substitute for gross figures in the ratio calculus; interpretation 2 leads to a double counting of the transactions.**
- Furthermore, EBA does not comment on the considerable impact for banks that have to comply with the leverage ratio at the individual level, notably regarding entities within the same group and in the same scope of prudential consolidation. Such entities will be

penalised by their transactions between them (for instance treasury centralisation required by national legislation for cooperative banks). In order to avoid a double-counting, this situation shall be taken into account, as Basel does not deal with individual leverage ratio.

- **The EBF does not agree with the conclusion of the EBA report on the absence of EU specificities.** In the view of the EBF further analysis is required regarding the importance of repo and reverse repos in European financial markets, and the differences in the mortgage model between the United States and Europe.
- Whilst the EBF acknowledges the revisions made to the draft Basel leverage ratio framework of June 2013, the EBF believes that the provisions of the Basel January 2014 exposure measure are too strict regarding the treatment of SFTs and derivatives, leading to an excessively inflated exposure measure. In EBF's view the Basel leverage ratio exposure measure still makes the leverage ratio the main constraint of regulatory capital and not a simple backstop measure, as it was the intention by regulators. **The EBF opposes any changes that makes the leverage ratio the main constraint of capital.**

On the basis of these concerns, **the EBF believes that the treatment of SFTs and derivatives in the Basel leverage ratio exposure measure of January 2014 needs to be analysed more in depth by EBA studies on reported data before taking any further steps.** The EBF elaborates on this view in the specific comments section below.

Moreover, the EBF believes that it would be worthwhile to give some **attention to the interplay between different BCBS measures.** More specifically, the EBF finds that the interplay between the LCR requirement and the leverage ratio should be taken into account. The LCR requirement urges banks to hold a stock of liquid assets on the balance sheet, which negatively impacts the leverage ratio. Though the EBA stated that they did not find empirical evidence for this interplay, the EBF finds this analysis is flawed. The conclusion of the EBA is based on the fact that no correlation was found between the speed of adherence to the LCR requirement and the leverage ratio. This does however not necessarily imply that there is no interplay between these measures. It could well be the case that the lack of correlation can be explained by the difference in timing: the LCR ratio will be binding from 2015 onwards, while the leverage ratio will kick in from 2018. It is clear that a leverage ratio requirement will introduce a substantial capital charge for banks' low-risk assets, such as the liquidity reserve. If the LCR eligible liquid assets are included in the denominator of the leverage ratio, banks will have a strong incentive to keep the size of the liquidity reserve to a minimum. It seems counterproductive from a financial stability perspective to incentivize banks to keep their liquidity reserve at the regulatory minimum, especially when it is important that banks in volatile times are able to increase their liquidity reserves. The EBF therefore suggest the Commission to reconsider the interplay and adjust for

this by exempting the assets used to fulfil the LCR requirement from the leverage ratio calculation.

Finally, as a more overall comment regarding the ongoing work on the CRR leverage ratio, the EBF finds that the European decision making process should be allowed to take its course. Hence, in order for the EBA process to be credible, **the EBF believes it to be important that Member States refrain from taking any policy actions implementing a national version of the leverage ratio during the calibration period.** Once the EBA report has been finalised, legislation should be proposed that incorporates the recommendations of the EBA report.

2. EBF specific comments

In EBF's view the BCBS June 2013 text was problematic because it penalised collateral in SFTs by not allowing any netting within repo and reverse repo transactions in the exposure measure of the leverage ratio. This represented a negative regulatory bias in favour of unsecured funding compared to secured funding, putting at stake the role of repo markets in the real economy. The EBF raised these concerns in its response to the June 2013 BCBS leverage ratio consultation⁵.

Whilst the BCBS January 2014 text has introduced some revisions, there still remain major problems regarding the treatment of SFTs. Firstly, it only allows for partial netting of cash legs between repos and reverse repos subject to restrictive conditions and secondly, it still denies any value to security collateral as it does not allow netting between the cash and the security legs in repos and reverse repo transactions. Hence, in the EBF's view the Basel III Leverage Ratio framework is still penalising SFTs. For a detailed example on repo netting and leverage ratio calculus see **appendix 1**.

Primary securities issuance activity is critical for the economy, but the secondary market transactions through SFTs play an equivalent role in supplying liquidity to finance the economy and enabling secondary market making in securities. SFTs are widely used to refinance stocks of public debt securities: in Europe government bond collateral account for about 80% of EU-originated repo collateral. They also enable companies to actively manage excess cash in a secure way. In particular, sovereign markets would suffer from severe disruptions as the sovereigns bond market is mostly supplied by repo transactions.

Equally there is a negative impact on corporate debt financing, i.e. corporates financing their activities by issuing debt in the primary market. The liquidity of the primary market is ensured by banks through SFTs on the secondary market. Punitive treatment of the SFTs will therefore seriously undermine the financing capacity of corporates by negatively impacting the liquidity supplied into the debt market by SFTs.

⁵ <http://www.ebf-fbe.eu/uploads/EBF%20response%20to%20consultation%20on%20Revised%20Basel%20III%20leverage%20ratio%20framewo%20%20%20.pdf>

The softened approach in the January 2014 Basel III text primarily matches the US practices without taking into consideration the European specificities. The repo markets indeed play a significant role in monetary policy transmission to the European economy, compared to the US. Therefore, the EBF believes that the Commission should carefully assess the impact of the January 2014 Basel III leverage ratio framework at European level.

Furthermore, the Commission should also keep in mind, that the Basel III Leverage Ratio framework should not be considered as completely stabilised. As mentioned in the introduction the GFMA, IIF and other associations have recently submitted a Q&A document raising a number of questions regarding the Basel III January 2014 leverage ratio framework⁶.

In addition to the problems mentioned above concerning the treatment of collateral and netting in relation to SFTs, the EBF wishes to point to four specific issues where the January 2014 Basel III leverage ratio text causes concerns:

1. Derivatives: *The condition of “same currency” to allow partial netting of cash variation margins in derivatives transactions (Paragraph 25(iii) in BCBS 270)*

Paragraphs 25 to 26 of the Basel III leverage ratio rules text introduced a treatment whereby variation margin paid in cash that fulfils five criteria can be deducted from the current replacement cost of the derivative (fair value). One criteria is that the cash variation margin is received in the same currency as the currency of settlement of the derivative contract.

A bank may execute numerous derivatives (like basic cross currency swaps) with a counterparty, all of which are governed by the same Master Netting Agreement (MNA). In some cases, these derivatives may provide for different currencies of settlement of contractual payments. The purpose of a MNA is to provide for a single netting structure to cover all of these positions even when denominated in different currencies. If the “same currency” criterion is applied on a narrow basis, inconsistencies would arise in the net exposure. MNAs necessarily rely on the principle that a single variation margin payment can be applied against multiple positions denominated in various currencies. Detailed examples are provided in the Q&A document submitted by GFMA, IIF and other associations⁷.

The condition in paragraph 25 (iii) of the BCBS 270 text should therefore be written as follows: *“The cash variation margin is received in a currency of the contract, which, for the avoidance of doubt, includes any currency allowed in the master agreement, transaction or master supplements or amendments, the credit support agreement or the confirmation”*

In the CRR, derivatives exposures are calculated according to Current Exposure Method / Mark-to-Market Method, without recognition of cash collateral. The delegated act should add the cash

⁶ http://www.futuresindustry.org/downloads/BCBS_LR_FAQ_cover_letter.pdf

⁷ Ibid. Pp.10-14

variation margin treatment as a subparagraph to Article 429 (6) of CRR by copying the relevant Basel rules text (paragraph 25) with the (iii) condition amended as proposed above.

2. SFTs: The condition of “same explicit final settlement date” (Paragraph 33(i)a in BCBS 270)

Paragraph 33 of the Basel III leverage ratio text allows for netting of repo and reverse repo cash receivables and payables, with the same counterparty subject to 3 conditions. One of these conditions is that transactions should have the same explicit final settlement date (paragraph 33.i (a)).

SFTs, however, do not always have an explicit final settlement date, as some of them are undated. This is the case of open or evergreen repos (in the EU), which are market practice in certain countries. In these cases, the transactions can be unwound unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day (US practice). We believe that these transactions should be treated as if they had a one-day maturity and that the requirement that they have the “same explicit final settlement date” should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The BCBS leverage framework would otherwise result in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos). The issue of European specificities for open end repos is further explained in [appendix 2](#) provided by an EBF member association.

The condition in paragraph 33(i)a should be written as follows:

“Transactions have the same explicit final settlement date, where settlement date for open transactions means the relevant call notice period”.

In the CRR, article 429 (9) refers to allow for netting for SFTs in accordance with Article 220 (1) - (3) and Article 222 CRR, but without any detail regarding the netting of cash receivables from repos/reverse repos. The delegated act should include a separate new paragraph in Article 429 (9) with the above amended BCBS 270 point 33(i) a.

3. The “settlement” criteria (Paragraph 33(i)c in BCBS)

Another of the conditions for netting of repo and reverse repo cash receivables and payables in paragraph 33 is that *“The counterparties intend to settle net, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date”* (paragraph 33.i (c)).

It is not clear what this condition means in the European and US contexts. This criterion seems more aligned with the US ‘tri-party repos framework whereby post-trade collateral selection, management and settlement are outsourced to a third-party agent (concentrated on 2 banks; JP Morgan and BoNY). For the European market tri-party repos only represent 10-12% of the market versus up to 66% in the US. The European repo market is more diversified, with more bilateral repos but also more cleared of repos through Euro-clear and Clear-stream.

The EBF believes that the following three types of settlement meet BCBS settlement criteria:

- 10% tri-party repo (which is more secure than in the US as explained below)).
- 30%-40% bilateral repos cleared through CCPs.
- 50%-60% other bilateral repos mainly cleared through Euro-clear and Clear-stream and in delivery-versus-payment mechanism.

The issue of European specificities vs US specificities for repos transactions settlement is further explained in **appendix 3** provided by an EBF member association.

Paragraph 33.i (c) also refers to “*linkages to collateral flows [that] do not result in the unwinding of net cash settlement*”. The EBF believes that this condition is intended to address that securities and cash should be settled on the same settlement system, which would be satisfied for most tri-party and bilateral SFTs, though not cross currency repo (for example, hard currency exchange offshore, securities onshore would therefore not be eligible) .

The condition in point 33.i (c) should be written as follows:

“The counterparties intend to settle net, or settle simultaneously or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount at the end of the settlement date. This will occur if the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk. To achieve such equivalence, both transactions are settled through the same settlement system, and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.”

In CRR, article 429 (9) refers to allowing netting for SFTs in accordance with Article 220 (1) - (3) and Article 222 CRR, but without any detail regarding the netting of cash receivables from repos/reverse repos. The delegated Act should include a separate new paragraph in Article 429 (9) with the above amended BCBS 270 point 33(i) c.

4. Calculation of on-balance sheet exposures (Point 15-17 in BCBS)

To ensure consistency between LR and LCR regulation it is proposed to exclude respectively adjust the exposure calculation of HQLA securities by adjusting point 15 and adding a new point 18:

15. (Adjusted) Banks must include all balance sheet assets in their exposure measure, including on-balance sheet derivatives collateral and collateral for SFTs, with the exception of LCR High Quality Liquid Assets (HQLA), on-balance sheet derivative and SFT assets that are covered in paragraphs 18 to 37 below

18. (New) To ensure consistency between LR and LCR HQLA should be weighted with their LCR haircuts in the LR exposure calculation: 0% for cash and level 1 securities, 15% for level 2 securities.

APPENDIX 1: REPOS netting and leverage ratio calculus, an example - Technical contribution from the French Banking Federation

Two banks A and B enter into two repos transactions, within a master netting agreement framework, legally enforceable.

In the first transaction, A borrows 1000 from B with collateral of securities X for 1025. In a second transaction, B borrows from A 800 with collateral of securities Y for 820. The settlement dates of the two transactions differ.

1. OPENING BALANCE SHEETS

A

Trading assets X	1025	Equity	60
Trading assets Z	175	Borrowings	1000
		Other liabilities	140
	=====		=====
Total assets	1200	Total liabilities	1200

B

Trading assets Y	820	Equity	60
Cash	680	Borrowings	1100
		Other liabilities	340
	=====		=====
Total assets	1500	Total liabilities	1500

2. ACCOUNTING FOR REPO TRANSACTION (= credit)

A

Trading assets X	(1025)	Trading assets X pledged	1025
Cash	1000	Repo payable	(1000)

B

Repo receivable	1000	Cash	(1000)
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3. ACCOUNTING FOR REVERSE REPO TRANSACTION

A

Repo receivable	800	Cash	(800)
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B

Trading assets Y	(820)	Trading assets Y pledged	820
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Cash	800	Repo payable	(800)
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4. CLOSING BALANCE SHEETS

A

Trading assets Z	175	Equity	60
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Trading assets X - pledged	1025	Borrowings	1000
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Repo receivable	800	Repo payable	1000
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Cash	200	Other liabilities	140
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Total assets	2200	Total liabilities	2200
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B

Trading assets Y - pledged	820	Equity	60
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Repo receivable	1000	Borrowings	1100
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Cash	480	Repo payable	800
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		Other liabilities	340
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Total assets	2300	Total liabilities	2300
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5. LEVERAGE RATIO

Assuming that the settlement dates of the repo and of the reverse repo differ, under Basel 3, art 33 prohibits netting. So, the leverage ratios are:

Basel 3

	Bank A	Bank B
Before SFTs	5 %	4%
After SFTs	2,73 %	2,61 %

Under CRR art 220 interpretation 1

Netting must portray faithfully the credit risk assumed by the institution. So, within a legally enforceable master netting agreement in event of default, bankruptcy or insolvency, for leverage ratio calculus, netting is permitted between borrowings (legs cash + securities) and loans (legs cash + securities). A net liability cannot be deducted from BS total.

For A: $(1025 + 800) - (1000 + 820) = 5$

For B: $(1000 + 820) - (1025 + 800) \neq 0$

The netting process cannot be made by accounting entries, as in a reverse repo, due to the accounting rules, the balance sheet does not show the posted collateral.

Leverage ratio after netting

A

Assets:

Trading securities Z 175

Collateral X 1025

Repo receivable net 5

Cash 200

=====

Total 1405

LR = 4, 27 %

B

Assets

Trading securities Y	820	
Cash	680	
	=====	
Total assets	1500	LR = 4 %

The amount added in the accounting figures for A portrays adequately the additional credit risk resulting from the two SFTs, which is generated by the haircuts on the securities. The risk for A is on the securities X sold under repo, less the securities Y received in the reverse repos, after taking into consideration the net of the two cash exchanges.

Conversely, B is a net debtor in the SFTs.

To summarise, in order to portray adequately the marginal credit risk added to the balance sheet by securities financing transactions executed within a master netting agreement, the measure of SFTs exposure should correspond, for an institution, to the total amount of security and cash given to a counterparty, less the total amount of securities and cash received from the same counterparty.



APPENDIX 2: EUROPEAN SPECIFICITIES FOR THE OPEN END REPOS - Technical contribution from the French Banking Federation

An open repo (also known as *on demand* repo) is a repurchase agreement that is agreed without fixing the maturity date. Instead, the repo can be terminated on any day in the future by either party, provided they give notice before an agreed daily deadline. Until an open repo is terminated, it automatically rolls over each day. Interest accrues daily but is not compounded (ie interest is not earned each day on interest accrued over previous days). Outstanding interest is typically paid off every month.

The repo rate on an open transaction will be close to the overnight repo rate, but it will not change until the parties agree to re-set the rate. Open repo is used to invest cash or finance assets where the parties are not sure how long they will need to do so.

The US repo market is mainly overnight, the maturity distribution of the European market is longer.

According to the 26th repo market survey (as of 11 December 2013 position) in January 2014. International Capital Market Association (ICMA) and the European Repo Council (ERC) , on December 2013, the sum of repo and reverse repo outstanding (gross values of cash due to be repaid by you and repaid to you) is reaching EUR 5,499 billion. In Europe, the split by remaining term of maturity is as following:

- 6% repos are **open end** (of which more than 50% are tri-party transactions)
- 20% repos are **overnight** (term maturity 1 day)
- 9% repos are **forward-forward**
- 65% repos have a **term maturity >1 day**
 - 2 days to 1 week 16 %
 - 1 week to 1 month 22 %
 - >1 month to 3 months 17 %
 - >3 months to 6 months 5 %
 - >6 months to 12 months 3 %
 - >12 months 3%

Open repos share was 6% in December 2011, 13% in December 2012, 7% in June 2013 and 6% in December 2013.

In the leverage ratio BCBS 270 text, the requirement of “the same explicit final settlement date” for netting the cash legs generates an unlevel playing field for European repo market:

* European repos have more maturities to match vs US repos with mainly overnight maturity

*Some European repos are open end

That is why we believe that BCBS and CRR texts should treat open repos as overnight repos.

APPENDIX 3: EUROPEAN SPECIFICITIES FOR REPOS SETTLEMENT - Technical contribution from the French Banking Federation

- a) US repo market is mainly based on a ‘tri-party repos framework, which represents 65%-80% of the transactions.**

Tri-party repo is a transaction for which post-trade processing --- collateral selection, payment and settlement, custody and management during the life of the transaction --- is outsourced by the counterparties to a third-party agent. In the US, there are only **2 clearing banks**: JP Morgan and Bank of New York Mellon.

Term repos in US tri-party systems have traditionally **unwound each morning**, to be re-arranged in the afternoon.

This was intended to give sellers (who are usually broker-dealers) the daily opportunity to substitute collateral and adjust for price fluctuations (instead of margining with the other party), but it requires the tri-party agents to finance the sellers for most of the day, creating a **systemic intra-day credit exposure**. Concern about the systemic risk posed by the huge intra-day credit exposures taken by the US tri-party agents have prompted **reforms to the US tri-party market** which are bringing it closer to the European tri-party model.

CF. The Federal Reserve in the 21st Century: Tri-party repo market reform, March 2013

CF. Federal Reserve Bank of New York: The Tri-Party Repo Market before the 2010 Reforms, November 2010

- b) The European repo market is more diversified in terms of settlement process, and more secure**

*According to the 26th repo market survey (as of 11 December 2013 position) published in January 2014 by the International Capital Market Association (ICMA) and European Repo Council (ERC), on December 2013, the sum of repo and reverse repo outstanding (gross values of cash due to be repaid by you and repaid to you) reaches EUR **5,499** billion.*

- b.1 - The bilateral transactions excluding those cleared through CCPs represent 50%-60% of the total European market share**

In Europe, most bilateral repos (both on a bilateral basis and tri-party) are settled via delivery-versus-payment mechanism, mechanism which links a securities transfer and a funds transfer in such a way as to ensure that delivery occurs if – and only if – the corresponding payment occurs.

Cf. CPSS – Strengthening repo clearing and settlement arrangements – September 2010; Annex 2: Cross-country comparison of repo markets and repo infrastructure arrangements in selected CPSS countries; (e) Settlement; P45-46-47-48).

The settlement is done through **Central Securities Depositories (CSDs)**.

The two largest continental Central Securities Depositories (CSDs) Clearstream and Euroclear concentrate around 65% of settled repo transactions. *This information is given by the European Securities and Markets Authority (ESMA) paper published in March 2014 “Trends, Risks and Vulnerabilities”.*

b.2 - The European market share of CCP-cleared (anonymous electronic) trading amounts to 30% -40%.

CCP is the acronym for *central (clearing) counterparty*. In some markets, they are known as *clearing houses*. CCPs perform two so-called *clearing* functions:

- Once a transaction has been agreed between two parties and registered with a CCP, the CCP inserts itself into the transaction (what was one contract becomes two) to become the buyer to every seller and the seller to every buyer. The CCP is AAA-rated, because it strictly collateralises its exposures; is backed by reserves, a default fund and other safeguards; and can ultimately fall back on its members. CCPs therefore provide attractive low-risk counterparties.
- The CCP will net transactions between members on a multilateral basis (netting by a CCP is referred to as “clearing”). This means that a delivery of a security due from parties A and B can be netted off against deliveries of the same security due on the same day to parties C and D. This produces a much smaller net exposure than bilateral netting, in which the parties can only net transactions with the same counterparty.

The proportion of repo turnover cleared across a CCP is likely to be even higher because the repos cleared in CCP tend to be short-term transactions (the ECB’s money market survey suggests in the order of 40%).

The principal CCPs clearing repos in Europe are LCH-Clearnet Ltd in the UK, LCH-Clearnet SA in France, Eurex Clearing in Germany, CC&G in Italy and MEFF in Spain.

Most CCP-cleared repos are negotiated on automatic repo trading systems such as BrokerTec, Eurex Repo and MTS.

b.3 - The tri-party repo transactions represent 10% of the total European market share.

The outstanding value reported directly by the major tri-party agents in Europe reached a record figure of EUR 1,344 billion.

The tri-party repo market in Europe is more secure than in the US, due to the fact that **tri-party repos in Europe are not unwound on a daily basis but subject to margining**. In European tri-party systems, there has always been true term repo. In Europe, the need to unwind tri-party repos daily has been avoided by the use of direct substitution and margining.

From the point of view of systemic risk, tri-party is not necessarily safer than bilateral. Tri-party agents, albeit they create economies of scale and scope for servicing the transaction, they DO NOT act as clearers, ergo they DO NOT guarantee the transaction, ergo DO NOT contribute to a decrease in the systemic risk. It is correctly shown in the chart that counterparties remain exposed to each other, same as in bilateral repos. Notably, it is the bilateral transactions which in most cases settle through DVP which is by far the safest way to ensure that transactions are finalised, settled, and cannot be unwound anymore.

Synthesis	Parties to the trade	Administrative tasks	Risks
1 - OTC Repos (on a bilateral basis)	Bank A trades Principal-to-Principal with Bank B	<ul style="list-style-type: none"> - <u>Calculation agent</u> : Bank A & B - <u>Collateral eligibility</u> : determined by the CSA between Bank A & B - <u>Settlement of payments</u> : Bank A & B (through their Back-Office teams) 	<u>Counterparty and settlement risks</u> against each bank
2 - Repos cleared through CCP	Bank A trades Principal-to-Principal with a CCP ("anonymous basis")	<ul style="list-style-type: none"> - <u>Calculation agent</u> : the CCP - <u>Collateral eligibility</u> : imposed by the CCP - <u>Settlement of payments</u> : Bank A & the CSDs (through their Back-Office teams) 	<u>Counterparty and settlement risks</u> against the CCP
3 - Tri-Party repos	Bank A trades Principal-to-Principal with Bank B and a Clearing Bank acts as agent	<ul style="list-style-type: none"> - <u>Calculation agent</u> : the Agent Bank - <u>Collateral eligibility</u> : contractual or either General Collateral (GC) - <u>Settlement of payments</u> : the Agent Bank 	<u>Counterparty risk</u> against each bank <u>Settlement risk</u> against the agent In addition : <u>Intraday Exposure</u> for the clearing Bank which finances securities during the day (the "unwind" in US market) to facilitate clearing and settlement activity of dealers

In the leverage ratio BCBS 270 text, the requirement of “settlement” criteria for netting the cash legs seems generating an unlevel playing field for European repo market, when the settlement is done on a bilateral basis, whereas bilateral transactions are settled through DVP and CSDs, which guarantee a functional equivalent of net settlement.

→ That is why the BCBS and CRR texts should be amended carefully to cover European repo market specificities. The re-worded 33(i)c in the BCBS 270 aims to cover all European repos

“*The counterparties intend to settle net*” – this is a catch-all, including CCP-cleared transactions

“or settle simultaneously” – this covers DVP

“*or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount at the end of ~~on~~ the settlement date. This will occur if the gross settlement mechanism has features that eliminate, or result in insignificant credit and liquidity risk.*” – this arrangement would have to apply for:

- a) transactions involving baskets of securities (where DVP is not possible because as it would require to go cash-against-ISIN for every single security in the basket and therefore there would rather be an aggregate settlement on the settlement date equivalent to net of all the legs),
- b) free-of-payment (FOP) purely bilateral transactions with the same counterparty, the same settlement date and the same ISIN number (which are settled leg-by-leg, as agreed by the counterparties)
- c) tri-party transactions, including transactions involving baskets of securities, where the settlement is internalized by the tri-party agent and it is done either simultaneously (i.e. it already falls under the previous criterion) or in most cases at the end of the day, on a net basis.

“To achieve such equivalence, both transactions are settled through the same settlement system” – this is satisfied for a) and b) above when transactions are settling in a CSD (or an iCSD), as well as for c) when the settlement is internalized by the tri-party agent.

“...and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.” – this would mean:

a) and b): in the bilateral context where there is no DVP (ie not settled simultaneously), this condition would require that the counterparty has an intraday credit line with its custodian.

c) in the tri-party context the tri-party agent would have to extend an intraday credit line to the counterparty for the purpose of securing the transaction. This is the case both for US and EU tri-party arrangements.

