London, 25 May 2012

BY ELECTRONIC MAIL

Dear Sirs,

ICAP response to FSB Shadow Banking Workstream - Interim Report on Securities Lending and Repos

ICAP welcomes the opportunity to respond to the Financial Stability Board's Interim Report on Securities Lending and Repos.

ICAP is the world's largest interdealer broker ("IDB"), intermediating over €1.6 trillion in trading across all asset classes daily. Our coverage of a wide range of products which are operated by regulated market operators increases investor choice and flexibility. ICAP is active in voice-brokered repo trading and increasingly in electronic repo trading through our BrokerTec platform. We also have some experience of electronic trading in security lending. As a result we would like to contribute to the FSB's work in this area but will limit our response primarily to issues relating to repo as this is where we have more significant experience.

Securities lending and repo are essential to market liquidity, efficient price discovery and moderate price volatility, helping investors to buy and sell securities. They facilitate capital raising and funding for financial institutions and non-financial companies. However, regulators are concerned about the potential for systemic risk to arise from the perceived procyclicality of collateralised financing.

ICAP welcomes the work of the FSB in considering these issues and notes that parallel initiatives are underway including the European Commission's Green Paper on Shadow Banking. We believe that a globally coherent approach is essential and would encourage the FSB to continue to ensure that these efforts are aligned as far as possible.

We would be happy to provide additional views if that would be helpful.

Yours sincerely,

Godfried de Vidts
Director of European Affairs, ICAP plc

i) Lack of transparency

We consider some of the concerns around repo transparency to be misplaced, both in terms of the accounting treatment and the overall transparency of the repo market.

The standard method of accounting for repo is to retain the collateral on the balance sheet of the seller. As the seller has committed to repurchase the collateral at a fixed repurchase price, he also retains the risk and return on that collateral. A cash asset and corresponding repayment liability are added to the seller's balance sheet, and this will expand to indicate increased leverage.

In relation to transparency of the repo market, there is already a large amount of information made available, as acknowledged by the Interim Report. This includes a twice yearly survey conducted by the ICMA's European Repo Committee (ERC) which provides an authoritative source of data on the size and composition of the European repo market.

Although greater disclosure may bring benefits both to the regulators and to the market, we would encourage policy makers to balance this carefully against the cost of any additional reporting. In particular any move towards the creation of a repo trade repository would need to be justified by a robust cost-benefit analysis.

We would also draw your attention to Richard Comotto's paper *Shadow banking and repo*, where these points are explored in more detail (see Section 9).

ii) Procyclicality of system leverage and interconnectedness

Richard Comotto's paper *Haircuts and initial margins in the repo market* [1] examines whether market practices in setting haircuts/ initial margins might amplify financial market pro-cyclicality. He concludes that the debate to date has focused on the repo market in the US, and that this does not necessarily read across to the structure and operation of the repo market in Europe. There has also been a narrow focus on the use of structured securities, which are not the predominant form of collateral used in either the US or European repo markets.

We would encourage the FSB to consider Mr Comotto's analysis as it continues its work in this area and also to take account of the European Repo Council's July 2010 White Paper (and subsequently updated) which provides a benchmark description of the European repo market[2].

iii) Other potential financial stability issues associated with collateral re-use

We would note that in some discussions there appears to be a misperception of what is meant by "re-use" and "re-hypothecation". These terms are not synonymous. Re-

[1] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts and initial margins in the repo market_8 Feb 2012.pdf

[2] http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/ICMA_ERC_European_repo_market_white_paper_update_Dec_2010[1].pdf

hypothecation applies to pledging. Typically, a pledgee cannot use the collateral that has been pledged (as the pledgor retains legal ownership). A repo transaction under the ICMA's Global Master Repurchase Agreement is not rehypothecation, as there is sale with full title transfer. In this "re-use" scenario, the pledgor does not retain a security interest, and the opening leg of the repo may be freely reused by the purchaser. (Of course the purchaser still has any obligation to resell when the date of the closing leg of the repo is reached and must cover this obligation accordingly).

In relation to the potential risks arising in a default by a default by multiple firms which have repoed out the same (re-used) collateral, we would draw attention to Richard Comotto's paper *Shadow banking and repo* (see Section 7).

iv) Insufficient rigour in collateral valuation and management practices

This section of the Interim Report refers to MBS collateral and the infrequency of marking-to-market and overoptimistic pricing models, which delayed the realisation of losses on collateral, ultimately causing greater disruption.

We note that in September 2005 the ERC published recommendations for a "Best Practice Guide to Repo Margining". These recommendations were recently revised to take account of current best market practice, and the ERC is promoting their adoption across the international repo market.

v) Mandatory haircuts

For ICAP's BrokerTec electronic trading platforms, government bonds are the predominant underlying collateral asset class, similar to our competitors both in the US and Europe. This market segment mainly consists of wholesale market users (commercial and investment banks) who use the repo markets to transmit secured liquidity to those in need of funding. As has been correctly identified in various studies the nature of these transactions are short term, although there is a remarkable shift towards longer than one month trades in Europe, due to the liquidity buffer requirements. (In the European repo market, short term markets - that is, one-day transactions – are estimated to comprise only 20% of the market). Imposing mandatory haircuts between wholesale market counterparties in this market segment would significantly restrict the flow of liquidity in financial markets. It would also run counter to the aims of the Basel II and II reforms by potentially encouraging a move away from secured to unsecured lending activities. As most of the volume traded on Broker Tec is centrally cleared the counterparty risk between market participants is managed through the CCPs used for unwinding these activities.

One development in electronic trading of repo is basket trading. These baskets can be pure government bonds but may also include non-government bonds. Settlement takes place in a tri-party environment and while still subject to further developments some centralised clearing already takes place. For electronic trading platforms the advantage of this form of trading is clear: there remains a centralised place for market participants while the haircuts applied on the underlying collateral are managed by triparty agents.

This market has developed as a direct result of the risk departments desire to protect firms against less valuable collateral (although recent events would also require some haircuts for EU government bonds).

Bilateral trading, mainly through our voice broker desks in government bonds, currently operates on the basis of no mandatory haircuts. It takes a considerable effort for market participants when haircuts are imposed on certain transactions for the simple reason that each firm's risk department has a different view on the value of collateral exchanged. The principal risk in repo transactions is counterparty risk, the use of collateral is a risk mitigation feature that require for non-government bonds trading different haircuts depending on the asset class. Hence a broad approach of generalised mandatory haircuts will make future market developments difficult, if not impossible for electronic innovation. It would also make our voice broking services to our customers more difficult, hence more expensive and deviate from the Basel approach towards more collateralised markets. We would therefore respectfully ask the FSB to consider a less intrusive approach of emphasising to market participants the careful use of haircuts for non-government bond financing activity, but allowing tailored-made (bespoke) solutions. Each national regulatory authority should assess on a regular basis the soundness of this approach.