

# SECURITIES LENDING AND REPO COMMITTEE

Tuesday 8 September 2009

Bank of England

## MINUTES

### Attendees

Chris Salmon	Bank of England, Chairman
Christian Hawkesby	Bank of England
Ronan Hodge	Bank of England, Secretary
John Hale	ABI
David Roberts	ACI
Anthony Littleton	APACS
Dasha Kazakova	Bank of America-Merrill Lynch
Wim Hautekiet	Bank of New York Mellon (BNYM)
Cassandra Kenny	BBA
Antony Baldwin	ERC / Daiwa Securities
Jane Karczewski	Deutsche Bank
Louise Riley	Deutsche Bank
Monica Sharma	Financial Services Authority
Geoff Heaton	HM R&C
Lisa Cleary	ICMA
Kevin McNulty	ISLA
James Templeman	ISLA
Nigel Bradley	LCH Clearnet
John Serocold	LIBA
Dagmar Banton	London Stock Exchange
Joyce Martindale	NAPF

## **1 Introductions**

**Mr Salmon (Bank)** greeted Members to the September SLRC and welcomed **Kevin McNulty (ISLA)** as the new Chief Executive of ISLA.

## **2 Minutes of the previous meeting**

The minutes of the previous meeting were agreed.

## **3 Matters Arising**

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

## **4 Market developments**

### **i) ICMA European Repo Market Survey**

**Antony Baldwin (ERC)** gave an overview of the findings from the recently published ICMA European Repo Survey, undertaken in June. He noted outstandings had increased 5.1% since the December survey, evidence that the European repo market was stabilising. This was said to be encouraging amidst ongoing deleveraging. He also highlighted the report that improvements in infrastructure and that the updated GMRA had been well received, had proved robust and were consequent with a decline in undocumented trades. It was also noted that the respondents to the survey had fallen from 90 last year to 60 this year.

### **ii) Update on market conditions**

**Antony Baldwin (ERC)** reported reasonably healthy conditions in repo markets. Whilst spreads in repo markets across the collateral markets had narrowed on diminishing credit concerns, lenders have maintained a cautious approach in their collateral schedules with haircuts of around 10% for less well traded/illiquid securities (compared to 5% pre-Lehmans). There was also some anecdotal evidence of institutions re-extending credit limits. **David Roberts (Fortis)** also noted that term markets (six to twelve month maturities) were starting to return as confidence improved though there are still concerns over what will happen once central banks reduce their support.

Central bank eligibility criteria was seen as a benchmark in repo markets by providing a backstop to the market. The spread for collateral eligible at the ECB is about 20bps tighter than for non-eligible collateral.

In the US, the Treasury Market Practices Group's (TPMG) fails charge was said to be working well with only a few repo trade fails though these weren't considered significant. The Bank-DMO gilt lending facility was viewed positively having removed the stress of negative repo rates.

Collateral profiles were said to remain under review at a number of lenders and collateral further down the credit spectrum was starting to be accepted again albeit with the more cautious approach to haircuts mentioned earlier. That said, there was still widespread avoidance in repo transactions of instruments that have remained impaired (e.g. CLOs, CDOs and ABS). Some counterparts were also accepting limited or no collateral from industries that had suffered particular duress in the crisis e.g. non-government guaranteed financials. On occasion this also extended to non-government collateral originating from particular Euro Area countries and this limited repo liquidity somewhat.

**Joyce Martindale (NAPF)** reported that larger and/or more sophisticated securities lenders were revaluating accepted collateral and haircuts. Larger schemes were said to be pushing for segregated collateral pools and more customised collateral programmes, though these were not thought to be suitable for smaller schemes on an operational / size basis. Beneficial owners were slowly returning to the market with risk reviews reported to be ongoing.

**Kevin McNulty (ISLA)** observed that lenders who had imposed more stringent risk constraints over the past year were not showing signs of relaxing these. Supply and demand in securities lending markets did not appear to be out of balance as demand for borrowing had fallen in line with the withdrawal of supply.

**iii) Discussion Topic: The next normal – how will securities lending and repo practice change as a result of the financial crisis?**

**Ronan Hodge (Bank)** led off a discussion of which we provide a summary.

Stabilising Volumes

The prospects for further increases in securities lending volumes were to some extent dependent on hedge fund involvement which was difficult to predict. That said their use of securities lending was reported to be have stabilised recently as the pressure from redemptions and deleveraging had reduced and they take on more trading opportunities.

Others reported that hedge funds and pension funds had switched some of their activity into swap markets (e.g. index matching) given some of the problems experienced in using securities lending markets in the past year and this may persist.

Going forward, regulatory developments for hedge funds, lending markets and banks capital and liquidity requirements were likely to be a key driver in the use of securities lending.

### Heightened Awareness of Risk

As the main suppliers of securities to the market, pension funds were said to be cautiously returning to the market having suffered from poor liquidity in some instruments at the height of the crisis. Beneficial owners were noted be relatively slow movers in these markets with legal agreements and changes to securities lending schemes taking time to implement.

Most considered the step-up in haircuts a structural rather than cyclical phenomenon and so likely to remain. However, some thought if volatility continues to fall this could lead to a fall in haircuts.

The liquidity of instruments was said to be key in determining whether participants were comfortable taking them as collateral. However, the assessment of liquidity remains subjective.

The cash collateral model was said to have fared badly in the crisis (though less prevalent in the UK than the US, where there has also been some negative publicity due to problems at money funds). This has led to reinvestment guidelines becoming stricter and an increased focus on non-cash collateral.

Proposals for a central counterparty model of securities lending were said to be still trying to gain traction. This could significantly change how the market operates and it was unclear what role agent lenders would have. Some thought the securities lending market may move to a broker system like the repo market.

Nevertheless, a switch in focus was reported from risk reduction to seeking returns for perhaps the first time in 18 months.

## **5 Regulatory developments**

### **i) CESR consultation on short selling**

**Kevin McNulty (ISLA)** reported that the CESR consultation on short selling is now out for review and ISLA and LIBA are forming a joint response. He thought this was significant because regulators globally are looking at short selling and if CESR can create a harmonised approach across Europe this would be helpful to participants.

ISLA and LIBA thought CESR's initial recommendations included a relatively low limit for disclosure (0.1% net position) which was potentially onerous and probably excessively low in terms of preventing market abuse. The tone of the consultation was also thought to have a strong bias against short selling failing to recognise the benefit short selling provides to market liquidity. **John Serocold (LIBA)** also noted they would be keen for a disclosure exemption for market makers and underwriters and they would continue to reiterate this.

### **ii) FSA Update**

**Monica Sharma (FSA)** updated the committee on the FSA's recent work.

A Securities Lending Overview is being conducted by Toby Wallis. Since April the FSA has been conducting a low key review of the conflicts of interest and risks associated with securities lending. They have spoken with a number of participants across the industry including beneficial owners and their advisers, agent lenders, hedge funds and industry associations. There will be an internal paper to be shared with HMT and they may revert to the SLRC and/or other industry bodies in light of any recommendations.

The CESR short selling consultation closes on 30 September and a feedback statement should be issued before the end of the year. Meanwhile, the FSA expects to be issuing a feedback statement on its short selling Discussion Paper around the end of Q3.

A Feedback Statement on the Turner review is due out shortly (around the end of the month). This will provide a summary of the responses to the FSA Discussion Paper accompanying the Turner review and the FSA's views on those responses.

## 6 Work Programme Updates

### i) ISLA Update

**Kevin McNulty (ISLA)** noted the CESR consultation is currently at the top of their work agenda. They are also involved in the FSA review on securities lending and are working with CESR on the issue of 'empty voting'. ISLA were planning to spend some time on education aspects and are running a securities lending workshop later this month. Work was said to be ongoing on best practice structures. Finally, having published the GMSLA 2009 in July, they are keen to encourage firms to sign up.

### ii) ERC Update

**Antony Baldwin (ERC)** noted they had responded to the European Commission on Mifid in respect of issuing DMOs and trading venues. He noted discussions were ongoing as to how to create a level playing field across trading venues, noting Italy as a particular concern and where repo liquidity could be affected. ERC continues to discuss and encourage the interoperability model for repo markets aiming for a harmonised approach by central clearing counterparties in respect of tri-party, where the current different methodologies adopted by two major central counterparties had thrown up an issue. Work continues on Geovanni barriers. A lawyers' working group on standardisation of agreements was noted, with the ERC supporting a discussion with all relevant parties the potential for improvement/consolidation of legal agreements. The ERC annual AGM will be held on 15 October in London.

**Lisa Cleary (ICMA)** noted there are two papers on the eligibility of credit claims in repo markets with an industry meeting in early October. She also requested the ERC garner feedback on the GMRA which they had begun to review noting they may deal with any urgent issues through a protocol.

## 7 Any other business

### Stock-lending and investment firm insolvency issues

**Wim Hautekiet (BNYM)** gave some background and updated the committee on developments with regard to ongoing netting issues in relation to the Lehman Brothers

International bankruptcy on Monday 15 September 2008 and the subsequent bankruptcy of Lehman Brothers in the US.

On Friday 12 September, the collateral provided by Lehman Brothers (US parent company) on its securities lending was rather difficult to allocate (as it had been delivered as bulk collateral, as usual). The allocation process resulted ultimately in some lenders being over collateralised whilst others had a deficit. Following the bankruptcy, those with an excess are required to return this to the administration whilst those with a deficit become ordinary creditors of the bankruptcy.

BNMY are a custodian bank engaged in agency lending as an intermediary between beneficial owners and borrowers of securities. BNYM would be favourable to exploring the possibility of netting across their clients in order to speed up the allocation of proceeds from the Lehman Brothers International (Europe) (LBIE) administration. Netting across lenders is generally not allowed, and netting aggregate collateral excess positions with deficit positions would amount to interfering with the ranking of creditors (and therefore be subject to approval by creditors and the court). Furthermore, collateral prices were very volatile in the five-day settlement period after the bankruptcy.

In response to a question from **John Serocold (LIBA)**, Mr Hautekiet agreed that in the normal course of business the cash collateral would have been received on the Friday night and processed on Monday morning. Whilst it could have been done over the weekend, after one year the allocation has still to be worked out.

BNYM provided indemnities for certain lenders, which was advantageous for their client base, but not for their proprietary position. They would consider netting their clients' claims in this situation; however, consent for a variation of GMSLA is required if entering into agreement with the administrators.

**Kevin McNulty (ISLA)** observed that in this case, cash collateral received by BNYM had not been allocated on the books and records of the agent to the beneficial owners at the point of the LBIE administration. He was not aware whether other agent lenders had experienced similar issues.

Mr Hautekiet noted that BNYM were exploring the issue only with trade associations at present rather than with the LBIE administrators directly. ISLA and LIBA will raise the ongoing issues with the relevant boards or committees.

#### Next Meeting

The next SLRC meeting is due to be held at the Bank of England on Tuesday 8 December 2009.