

SECURITIES LENDING AND REPO COMMITTEE

Thursday 28 September 2006

Bank of England

MINUTES

Attendees

David Rule	Bank of England, Chairman
David Hopton	Abbey Financial Services
John Hale	ABI
David Roberts	ACI/RBS
Anthony Littleton	APACS
Alex Merriman	BBA
Nick Fisher	DMO
Warren Alsop	Euroclear
David Wyatt	Euroclear
Cameron Dunn	European Repo Council/Merrill Lynch
Christian Krohn	Financial Services Authority
James Woodley	Financial Services Authority
Michael Knight	Financial Services Authority
Steve Russell	HSBC
Gregor Pozniak	ICMA
Christian Hellmund	ICMA
Hugh Gibson	ISLA
Laurence Marshall	ISLA/UBS
Richard Steele	ISLA/JP Morgan
John Burke	LCH.Clearnet
John Serocold	London Investment Banking Association
Ian Fox	London Money Markets Association/ HBOS
Dagmar Banton	London Stock Exchange
Joyce Martindale	National Association of Pension Funds/Railpen
Mark Austen	TBMA
Volinka Reina	TBMA
John Richmond-Scott	Bank of England, Secretary
Also present:	
John Rippon	Bank of England
Chris Becher	Bank of England
Chris Yeates	Bank of England

1 Introduction

The chairman welcomed new members David Hopton (Abbey Financial Services), James Woodley (FSA), Gregor Pozniak (ICMA), Christian Hellmund (ICMA) and Chris Yeates (Bank of England).

2 Minutes of the previous meeting on 22 June 2006.

The minutes of the previous meeting were agreed.

3 LCH.Cleernet Gilts DBV service.

John Burke (LCH.Cleernet) updated the group on the RepoClear Sterling GC service, which was scheduled to go live on 23rd October¹. 19 participants had signed up to the service, with several more expected in November/December. European participants had also shown some interest. Some participants had raised questions around the potential impact on sterling liquidity flows during the day. LCH.Cleernet had arranged bilateral meetings to discuss liquidity issues. Mr Burke also mentioned that the new service would not allow negative rate repos.

LCH.Cleernet had received a positive opinion regarding members' balance sheet reporting of exposures on a net basis, where participants are trading both sides of the market through the new service for Sterling GC repos with the same maturity date. Currently it would not be possible to net a term trade against an overnight trade in the balance sheet, unless the term trade was represented as a series of one day repo trades, each with a separate repo interest payment. A way of addressing this issue and thus enabling enhanced balance sheet netting was being considered as a product enhancement in due course.

Mr Burke noted that only around 25% of the Gilt DBV market was accounted for by the interbank market and that only around half of market participants had currently subscribed. In addition, there would likely be a transition period as participants familiarised themselves with the new product. Therefore, it was not expected that the netting effect would be significant at

¹ This has been subsequently been delayed pending further stabilisation of CREST DBV settlement (see below).

the outset, although it would potentially increase gradually over time. Some changes in trading patterns could also be expected, although the exact nature of these was not yet clear.

4 **CREST Single Settlement Engine (SSE).**

David Wyatt (Euroclear) reported on the CREST issues that had arisen since the go-live of the SSE on 29 August.

Issues had arisen on the 29 August towards the end of the settlement day, requiring settlement extensions for DBVs (for Gilt DBVs this normally takes place between 15.00 and 16.10) and a very substantial CHAPS extension for payments. Mr Wyatt explained that before Gilt DBVs were settled, the stock position had to be reconciled to ensure that beneficial owners received any payments due as a result of stock events. On 29 August, which coincided with the end of a quarter and corresponding coupon payments, substantial numbers of gilts positions needed confirming. This reconciliation process was delayed and a settlement extension called.

Settlement (and CHAPS) extensions had also been called on several days since go-live. DBV processing had generally been slow to start due to valuation of cash positions taking longer and there had also been performance issues at the end of DBVs, forcing extensions to allow customers to complete their collateral activity. Typically an extra half hour of processing time had been required. Since mid-September the settlement timetable had reverted to normal most days, although further extensions had been called. All sterling business had eventually been settled on all settlement days.

On two occasions settlement interruptions had prevented completion of euro DBVs before the euro deadline. As euro and dollar payments were currently coupled as a single category, some collateral activity against dollar payments had also failed to settle. This had left some participants with their pre-collateralised positions and unusually long or short of cash. Subsequent to the performance enhancements mentioned below, euro and dollar business had been completed well in advance of settlement deadlines.

There had also been an issue around the allocation of stock in 'splitting' transactions where some participants had found securities not being optimally allocated to settle transactions. This was expected to be resolved in the next few weeks.

Mr Wyatt said that Euroclear were trialling several fixes that should improve the DBV allocation and settlement processes in particular, and were considering whether market players could be involved in testing. Euroclear had learned lessons from the current issues and would ensure that performance testing (in particular for time-critical windows), as well as functional testing, was built into future trialling programmes; that the forthcoming Euroclear Bank release applied these lessons; and that stock events were also monitored carefully in the context of future releases.

Members discussed what guidance was available should settlement fail and participants find themselves with unexpected cash positions. Mr Rule outlined the current arrangements (detailed in the Bank's Red Book), for the Bank to narrow the rates on its Standing Facilities and roll intraday positions overnight, in the event of major disruption to sterling markets or their supporting infrastructure. Euroclear were taking forward discussions with the banks to determine what actions would be appropriate for Euro and US dollar positions.

5 TRAX 2

Gregor Pozniak (ICMA) updated the Committee on TRAX 2 which had extended the existing TRAX functionality to matching across all principal asset classes: bonds, equities, derivatives and repos. There would be more flexible reporting under TRAX 2, with post-trade reporting to meet MiFID level 2 requirements as they currently stand. Further details are provided in Annex 1.

6 Idiosyncratic volatility in the overnight gilt repo market on 31 July

David Rule said that the Bank had been concerned at the very low level that gilt GC repo rates had reached on the 31 July, apparently reflecting a shortage of gilt collateral in the overnight repo market. The Bank was currently meeting with market contacts in the gilt repo and securities lending markets to understand the factors behind the fall in rates.

The Bank had implemented amendments to its collateral substitution policy, to allow gilt DBV collateral to be substituted against euro collateral later in the day, thus allowing gilts to be released should collateral become scarce.

Committee members were unable to explain the shortage of gilt collateral in the overnight repo market on that day. Members were not aware of any significant recalls of lent gilts at that time.

7 Updating the Gilt Repo Code

Mr Rule said that the Gilt Repo Code of Conduct was out of date. There was a question about the need for a Code now that the market was established. But if the Code was still useful, it needed to be updated to address current issues in the market. Mr Rule asked for any immediate reactions on the need for a code and, if so, what updates could be required.

Members noted that there had been no major issues in the gilt repo for some time, although occasionally small things arose, for example if a trade was submitted late to LCH.Clearnet and failed, would LCH.Clearnet then automatically re-instruct it the next day? A Code was also thought useful for new market participants.

Mr Rule emphasised that an update would required broad engagement from the market. The Bank would write to all OMO counterparties to ask for their views and report back at the next SLRC meeting.

8 Transparency Directive

Christian Krohn (FSA) reported that the Transparency Directive was in the final stages of implementation. The FSA would publish a policy statement in October containing near final rules. The final level 2 requirements had not yet been approved by the European Commission and European Parliament and this was expected in December. Any revisions to the requirements would be reflected in the final UK text, although it was expected that these would be minimal.

Legal issues had been raised over the proposal to exempt lenders from making major shareholding disclosures, by allowing them to treat their right to recall lent stock as an 'acquisition' to be set-off against their lending/'disposal' of the stock. These issues had been resolved and the near final policy statement would reflect that agreement had been reached on this approach.

The notification requirements would generally apply to securities borrowers. However, requirements for intermediaries which borrow securities with the intention to on-lend these securities within a short time period were currently being discussed. The FSA thought that it might be possible to define rules in such a way that these intermediaries were exempt from notification, provided that they did not exercise voting rights and they did on-lend within a given time period.

The Committee discussed the notification requirements for such intermediaries. Some members agreed that notification should not be required in these circumstances, but that it could be difficult to codify this in regulation, in particular the intention to vote. Notification by intermediaries who on-lend could, in fact, create less transparency by making it more difficult to establish who ultimately was borrowing the securities. It also was thought that settlement failures should also be taken into account, as they could cause custody of securities to be longer than intended thus triggering unnecessary notification requirements. However, other members raised concerns that such exemptions could mean securities would be borrowed for voting purposes or clients could instruct intermediaries to build up temporary positions, for example during a hostile takeover, without having to notify.

9 **Markets in financial instruments directive (MiFID)**

Mike Knight (FSA) updated the Committee on MiFID developments. A Consultation Paper on conduct of business rules, including client classification, would be issued in October. An informal paper on implementing MiFID's client classification requirements had been issued in August and feedback had been generally positive. A feedback statement would be included in the October CP. Mr Knight noted that, as now, under certain circumstances, clients would be able to move between categories (i.e. increasing or decreasing the level of regulatory protections afforded), but that policy regarding this was not yet final.

Regarding best execution, the FSA had issued a Discussion Paper in June and had received a response from many parties including ISLA's response regarding securities lending and borrowing. Mr Knight reported that there were still issues around the legal interpretation of investment services versus investment activities. These issues were still being discussed, but the Committee should expect to see the outcome of this in the October CP.

Richard Steele raised the issue of the exclusion of securities financing from the definition of 'purchase and sale of a financial instrument', as stated in the Level 2 MiFID Regulations. It was also questioned why the definition varied across different Directives and whether there could be any read-across. The FSA agreed to look at this issue as part of its continuing policy and legal analysis.

Benchmarking was also discussed, in particular the possible difficulties of finding practical price benchmarks for securities financing transactions. ISLA offered to provide further information on this and were keen that any benchmark measure proposed would have to be a valid measure of performance. The FSA responded that measurement would need to be considered in the context of the market. It was thought that benchmarking could be one possible way to show compliance with best execution, should it be required for securities financing, rather than a requirement.

10 Status on harmonisation of the legal opinion gathering exercise

Mr Rule reported that the trade associations concerned (ICMA, TBMA, ISLA, and LIBA) had met recently to discuss harmonisation. It had been agreed that efforts to harmonise the legal opinion gathering process for securities lending and repo agreements would continue. Potential savings of a harmonised process had been identified in terms of direct legal costs and time spent reviewing opinions by internal counsel. It would be likely that a harmonised approach would be taken with a single opinion being obtained for each jurisdiction.

The opinions would be formatted with separate annexes for lending and repo and these would be provided separately to subscribers. Regarding funding, it looked likely that opinions on the GMRA would continue to be provided as a benefit of ICMA membership and opinions on the

securities lending agreements on a subscription-basis, as now. There would also likely be a harmonised governance process, with representatives from repo and securities lending markets.

11 SLRC Netting sub-group: SLRC Netting legal opinions

John Serocold (LIBA) informed the Committee that the SLRC Netting subgroup would meet on 6 December to inform subscribers to the opinions on securities lending agreements of current progress. TBMA and ICMA would also attend this meeting and had agreed to meet separately to discuss funding issues. Other issues would include counterparty and jurisdiction coverage.

12 GMRA: updated legal opinions

Gregor Pozniak (ICMA) updated the SLRC on GMRA-related issues and progress in the current round of opinion updates. More details are provided in Annex 2.

13 Any other business

Dagmar Baton (LSE) reported that the LSE were in the process of reviewing the Stock Exchange Rulebook in light of MiFID requirements. They would carry out a thorough market consultation in due course

Mr Rule noted that the annual tripartite market-wide continuity exercise, based on a flu pandemic, would start on the 13th October. The SLRC would not be involved unless the exercise raised questions about repo and securities lending markets specifically.

The next SLRC meeting (and buffet lunch) will take place on 6 December at the Bank.



TRAX

- Functionality limited to matching and reporting of OTC bonds and equities.
- Onward processing to clearers not supported.
- Expensive leased line connectivity.

TRAX 2

- Matching across all asset classes: bonds, equities, derivatives including futures & options, CFDs, repos.
- Repos to include open, buy/sell-back, and term.
- Open to both buy & sell side.
- Rapid identification and – therefore – rectification of problem trades; as a consequence greatly reduced number of failed trades.
- Narrative fields to communicate any problems directly to counterparties.
- Real-time exchange of standing settlement instructions (SSI's) between counterparties.
- Bank Identifier Codes (BIC) for place of settlement to be included.
- ISO 15022/20022 messaging formats allowing for greater systems integration.
- Regulatory reporting hub to facilitate MiFID Article 25 transaction reporting.
- Internet and FTP connectivity allowing for simple and cost-effective access.
- 24/7 – 365 service availability.

For further information, please contact Paulo Costa (paulo.costa@icma-group.co.uk) at ICMA, Tel. 0207 510 2681.

Stock Lending and Repo Committee (SLRC)

Meeting, September 28, 2006, London

ICMA's update on Global Master Repurchase Agreement (GMRA) related matters

1. Legal opinions

1.1 2006/7 update exercise

ICMA will start with the preparation of the 2006/7 opinions updating exercise in October 2006. As in previous years ICMA intends to publish the updated opinions at the end of March 2007.

Following requests from several member firms ICMA will in future also publish mark-up versions of the updated opinions when publishing the annual update opinions.

1.2 Czech Republic

ICMA recently published the new opinion for the Czech Republic on ICMA's website.

1.3 Slovakia, Slovenia and Israel

Revised drafts of new opinions for Slovakia and Slovenia are currently being reviewed by ICMA. The opinions for these jurisdictions are expected to be finalised shortly.

Based on a respective recommendation of the ERC committee ICMA recently instructed local counsel to produce a new opinion for Israel.

TBMA have yet to confirm whether they will join ICMA in obtaining these new opinions.

1.4 Croatia, Malaysia, Romania and Russia

In relation to Croatia, Malaysia, Romania and Russia ICMA is continuing to monitor legal developments with a view to ascertaining at what stage a clean opinion can reasonably be expected for each of these jurisdictions.

1.5 GCC (Gulf Cooperation Council) countries

At its meeting on September 13, 2006, the ERC committee expressed an interest for opinions from GCC countries currently not yet available i.e.

Qatar and Oman. ICMA is therefore arranging for a review of whether clean opinions can in fact be obtained for these jurisdictions.

Christian Hellmund
September 25, 2006 /TH/CH