







**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **Shadow Banking: Legal issues of collateral assets and insolvency law**

## **NOTE**

### **Abstract**

In many financial markets repurchase agreements (repos) and securities lending agreements benefit from special insolvency treatment which - broadly speaking - consists of an exemption from a number of insolvency law mechanisms. In line with FSB Recommendation 13 on repos and securities lending, insolvency treatment of these transactions should not be changed. Instead, the regulators should be given the power to temporarily stay close-out netting, as in bank resolution proceedings. Regulatory haircuts (FSB Recommendations 6 and 7) may buffer systemic consequences but are unable to act as a circuit breaker.

Repo and securities lending collateral assets face increased enforcement difficulties in cross-border settings, stemming from different national rules regarding good-faith acquisition and close-out netting. Haircuts are not an appropriate solution. Instead, only harmonisation of securities law and of the relevant insolvency rules can guarantee a consistent cross-border framework.



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## EXECUTIVE SUMMARY

In this note we address two different spheres of legal issues surrounding collateral assets, changes to insolvency law and mandatory haircuts which arise in the context of Recommendations 13 and 7 of the Financial Stability Board ('FSB') '*Policy framework for addressing shadow banking risks in securities lending and repos*'.<sup>1</sup> Annex 1 and 2 provide a basic introduction into repos and securities lending, as well as close-out netting, risk management and capital requirements for those who might not be familiar with these topics.

**In the first part**, we explore the question of whether the special insolvency treatment currently afforded to repurchase ('repo') and securities lending transactions should be changed for the sake of higher systemic stability, and whether regulatory haircuts could contribute to solving this issue.

Repos and securities lending are afforded a special treatment in that they are not stayed at the moment of the commencement of insolvency proceedings. As a consequence, the solvent party can still operate a 'close-out netting' provision which is generally included in the repo or securities lending contract. On the basis of close-out netting, all mutual obligations are terminated, valued and set-off against each other. Any collateral provided to the solvent party can be immediately sold on the market. Further, under the relevant rules, collateral provided shortly before insolvency under a margining mechanism cannot be clawed back by the insolvency administrator. A number of academics have proposed to abolish or limit this special treatment, as the mass close-out of transactions and the following mass-liquidation of collateral on the market ('fire sale') could show adverse systemic effects, notably a downward spiral of asset prices, potentially exacerbating pressure on financial institutions in a crisis. In its Recommendation 13, the FSB has stated that changing the treatment of repo and securities lending transactions in insolvency law might be a viable theoretical option to limit systemic risk, but that this option should not be prioritised for further work at this stage due to significant difficulties in implementation.

The ECON report on shadow banking<sup>2</sup> has left this question expressly open for further review. Our analysis shows that the perceived risks flowing from close-out netting may exist but generally are only the flipside of the advantages of that mechanism. Notably, close-out netting is itself the number one risk mitigation tool, alongside collateral, used in the entire financial wholesale market. It reduces counterparty risk by up to 85%. The international regulatory community, including the FSB, agrees on these beneficial effects and unanimously underlines its importance. The mechanism is enshrined in the risk calculation under the Basel II (and now III) Accord. Further, all central banks, including the ECB, and all infrastructures, including CCPs, use it in their daily operations. Close-out netting and margining are part of the *acquis communautaire*.<sup>3</sup>

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<sup>1</sup> Financial Stability Board, Consultative Document, Strengthening Oversight and Regulation of Shadow Banking – A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, 18 November 2012.

<sup>2</sup> European Parliament, Committee on Economic and Monetary Affairs, Report and Shadow Banking, 25 October 2012 (Rapporteur: Saïd El Khadraoui, S&D), para. 28.

<sup>3</sup> Articles 7 and 8 Directive 2002/47/EC on financial collateral arrangements, as amended ('Financial Collateral Directive'); Article 25 Directive 2001/24/EC on the reorganisation and winding up of credit institutions.

However, fire sales can never be entirely excluded and thus it needs to be discussed what can be done against the potential negative systemic consequences.

- We advise to copy a tool which has recently been developed in the context of bank resolution proceedings to the shadow banking sector: Regulators should have the power to halt close-out netting for a short period of time, e.g. 48h or until 5pm of the next business day. This can fend off imminent threats from fire sales while at the same time close-out netting is upheld as a risk mitigation tool.
- We strongly advise against any modifications of the insolvency treatment of repos and securities lending beyond the possibility of such temporary stays.

Further, the analysis confirms that the stabilising potential of minimum regulatory haircuts to the collateral assets, as contemplated in FSB Recommendations 6 and 7, also covers any risk that might flow from fire sales which might occur as a consequence of the special insolvency treatment of repos and securities lending. However, this additional buffer can only soften harmful effects of fire sales; it cannot act as an absolute circuit breaker. This is why the combination with the temporary-stay tool, above, makes sense.

**The second part** examines the question of whether there are enforcement issues or stability concerns linked to difficulties in enforcing repo or securities lending collateral in a cross-border context, and whether such difficulties, to the extent they exist, should be factored into the setting of regulatory minimum haircuts.

- We confirm that such enforcement issues and stability concerns exist.

The first concern identified in this note relates to the fact that financial instruments used as collateral in repo and securities lending transactions need to be delivered between the parties. This delivery implies a transfer of property from the collateral provider to the collateral taker. However, in a cross-border (or better: cross-jurisdictional) situation, the legal transfer tends to be more complicated. Therefore, there is a higher risk of the transfer being invalid or otherwise defective. As repo and securities-lending collateral is often re-used in further securities financing transactions<sup>4</sup> it is important that a first defective acquisition does not become the source of a chain of subsequent defective acquisitions of the same collateral assets. In other words: the repo and securities lending market heavily relies on 'good faith acquisition' of the subsequent acquirers. However, good faith acquisition does not necessarily work in a cross-jurisdictional setting and is not protected by the Financial Collateral Directive.

The second problem identified in this note relates to the enforcement of repo and securities lending collateral. In the event of the insolvency of one of the parties, the other party usually 'enforces' its rights, including the collateral, by the operation of close-out netting. However, in cross-border repo and securities lending, parties generally agree that English law applies to their agreement, including to the close-out netting provision. Should the insolvent party be in a jurisdiction other than England, the national insolvency law and the English-law-governed close-out netting provision might be incompatible. As a consequence, enforcement of the collateral might become impossible as in these situations insolvency law will generally prevail. The Financial Collateral Directive removes much of that risk, albeit not all of it and cannot protect cross-jurisdictional situations involving the insolvency of a third-country financial institution.

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<sup>4</sup> Financial Stability Board, Securities Lending and Repos: Market Overview and Financial Stability Issues, 27 April 2012, pp. 1-5.

- We advise that regulatory haircuts are an *inappropriate* means to address these risks. They are obviously unable to remove the risk itself, neither are they able to contain the immediate negative effects flowing from the risk. Further, the idea of taking cross-jurisdictional risk into account in setting haircuts is operationally difficult to realise and probably incompatible with the concept of the Single Market.

Instead, the risks inherent in cross-jurisdictional repos and securities lending are a clear reminder that a pan-EU financial market cannot work smoothly without a consistent and clear underlying legal framework, covering parts of the insolvency law and the securities law.

# 1. INSOLVENCY LAW TREATMENT OF REPOS AND SECURITIES LENDING

Repurchase agreements ('repos') and securities lending agreements<sup>5</sup>, together with certain other types of transactions, in most developed financial markets, benefit from a special insolvency<sup>6</sup> treatment. It consists, broadly speaking, of an exemption from a number of insolvency law mechanisms to the extent that the transactions are entered into by financial institutions. Rules to that effect can take one or the other form depending on the concrete jurisdiction.

The FSB Work Stream 5, in Recommendation 13 of its consultative document<sup>7</sup>, stated that changing insolvency law treatment of repo and securities lending transactions might be a viable theoretical option to limit systemic risk flowing from this privilege, but should not be prioritised for further work at this stage due to significant difficulties in implementation.

We are asked to shed additional light on this question, i.e., to see whether limiting or abolishing the special treatment for repos and securities lending transactions could not be employed to decrease systemic risk in the shadow banking sector. Also, we shall discuss whether minimum regulatory haircuts<sup>8</sup> to the collateral assets transferred in repo and securities lending transactions might have the potential to decrease that risk.

## 1.1. Background: FSB Recommendation 13 and the special insolvency treatment

The existence of the special insolvency treatment for repos and securities lending agreements is of tremendous importance for the securities financing market in its present form and for the wholesale financial market in general. This special treatment has two basic components:

First, the relevant transactions are not subject to the typical insolvency stay that applies to all open contracts of the insolvent party with its counterparties as from the moment of the opening of the insolvency proceedings and contractual close-out netting continues to apply.

Second, these contracts are also exempted to some extent from the principle of equal treatment of creditors ('*pari passu*' principle) which traditionally allows the insolvency court to avoid and 'claw back' transactions that it deems to afford a preferential treatment to a creditor.<sup>9</sup>

The special insolvency treatment is a building block of the EU *acquis* in the area of financial law, notably in the Financial Collateral Directive ('FCD'), and consequently exists in all Member States.<sup>10</sup>

<sup>5</sup> For an explanation of repurchase and securities lending agreements see [Annex 1](#).

<sup>6</sup> In the following we use the term 'insolvency' (instead of 'bankruptcy') as the more generic term also used in the context of EU legislation. For an explanation of insolvency principles see [Annex 2](#).

<sup>7</sup> Financial Stability Board, Consultative Document, Strengthening oversight and regulation of shadow banking, A Policy Framework for addressing shadow banking risks in securities lending and repos, 18 November 2012 (hereinafter: 'FSB Consultative document on securities lending and repos').

<sup>8</sup> 'Minimum regulatory haircuts' is the base reference used by the FSB to introduce the different types of haircuts, i.e. (a) regulators imposing minimum standards for methodologies used by market participants to calculate haircuts, and/or, (b) regulators imposing binding numerical haircut floors, *cf.* FSB Consultative document on securities lending and repos, sections 3.1., 3.2. and 3.3.

<sup>9</sup> The FSB Consultative document on securities lending and repos, Recommendation 13, mentions only the stay, however, the exemption from *pari passu* is equally important.

<sup>10</sup> Articles 7 and 8 Financial Collateral Directive.





















































terminated by the parties at any time. In mid-2011, the average daily repo turnover on euro area money markets was around EUR 440bn.<sup>63</sup>

In order to be sufficiently collateralised and to protect against not fully liquid markets, repo financiers regularly require a 'haircut' to the value of the repo-ed assets, which varies depending on the perceived riskiness of the collateral between an average 2.7 % for repo-ed government bonds and average 8.7 % for repo-ed mortgage-backed securities.<sup>64</sup> This haircut applies on a contractual basis between the parties on the basis of normal risk management considerations; there is no general regulatory or mandatory haircut on repo-ed assets. In general, very liquid and highly rated assets are used as collateral in repo transactions. Assets consist of 37 % government bonds, 10 % public agencies' bonds, 8.7 % corporate bonds and 20 % of equity. AAA ratings are 37 %, AA 24 % and below BBB only 3.7 %.<sup>65</sup>

As the market value of the collateral may move between its initial provision and maturity date, parties constantly monitor it ('mark-to-market') and normally on a daily basis. To the extent fluctuations occur, the level of collateral is constantly adjusted ('variation margins').

Repos can be set up on a bilateral basis or on a tri-party basis, in which case the collateral is held in safe-custody by a service provider and returned at the maturity of the repo unless termination events arise. Repos can also be cleared through central counterparties (CCPs). For the purposes of this briefing, that distinction is however irrelevant.

### ***Securities lending: structure, purpose, maturity and collateral characteristics***

Market data on securities lending is scarce and nearly exclusively provided by commercial data providers.<sup>66</sup> Following a Bank of England paper securities worth about USD 2bn were on loan world-wide mid-2011, down from a peak of USD 3.8bn in 2008.<sup>67</sup>

A securities lending transaction is very similarly structured to a repo. Here also, the original owner ('lender') delivers the securities to the other party ('borrower') against transfer of cash collateral.<sup>68</sup> In legal terms, however, the transaction is not structured as a 'loan' in the proper sense of the term. Rather, again, the securities are sold and the ownership is transferred leaving the obligation to reverse the whole action at a later point in time. Obviously, a fee is paid to the lender.

A difference between repo and securities lending transactions mainly consists in the diverging needs (repo are generally cash-driven whereas securities lending is driven by the need for specific securities, though this distinction is partly blurred). Financial market participants use securities lending arrangements for a variety of purposes, in particular as market maker or in order to cover settlement obligations after a delivery failure, or in the context of contractual early settlement. In this way, market liquidity is improved. Or, market participants borrow securities in order to have sufficient eligible collateral at their disposal when they enter derivative transactions that are cleared through a CCP. Lastly, securities lending is often used as the basis of short selling strategies. Securities lenders

<sup>63</sup> K Bakk-Simon, S Borgioli *et al.*, *Shadow banking in the Euro area – An overview*, ECB Occasional paper series No. 133, April 2012, p. 17.

<sup>64</sup> ICMA, *ibid.*, p. 26.

<sup>65</sup> ICMA, *ibid.*, p. 18.

<sup>66</sup> FSB, *Securities lending and repos: market overview and financial stability issues*, 27 April 2012, p. 31.

<sup>67</sup> M Dive, R Hodge and C Jones, *Developments in the global securities lending market*, BoE Quarterly Bulletin 2011 Q3, p. 224. This paper provides an excellent general introduction to the securities lending market. There is some more detailed data listed in FSB, *Securities lending and repos*, pp. 31-33.

<sup>68</sup> Under a securities lending agreement it is equally possible to that the lent securities are collateralised by securities of a different kind. I.e., in such cases, securities are exchanged against securities. However, for the sake of simplicity we will assume, in the following, the situation that there is a securities leg and a cash leg. Should there be two securities legs, the considerations of this briefing apply equally to both of them.

(often investment funds, pension funds, insurance companies) are motivated by the need to generate additional income, roughly USD 6.5bn in 2010.<sup>69</sup>

The duration of the contract is generally open, i.e. it can be terminated by the parties at any time.<sup>70</sup> Collateral and margining mechanisms are comparable to the ones described before. As with repos, securities lending can be structured bilaterally or through intermediaries.

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<sup>69</sup> Dive *et al.*, *ibid.*, p. 226.

<sup>70</sup> Dive *et al.*, *ibid.*, 227.

## **ANNEX 2 – DETAILS ON CLOSE-OUT NETTING, RISK MANAGEMENT AND CAPITAL REQUIREMENTS**

Recommendation 13 of the FSB mentions that repos and securities lending is exempt from 'automatic stay' in case of the commencement of insolvency proceedings in respect of one of the parties.

### ***Traditional insolvency principles***

Under traditional insolvency law principles, which are of quasi-universal application, all open contracts entered into by the insolvent with its counterparties are immediately stayed at the moment of the opening of the proceedings. This means that the insolvent and its counterparties cannot perform on their contractual obligations anymore. The intention behind this principle is to two-fold. First, to avoid a run of the insolvent's creditors on the insolvent estate with a view to execute their contracts before other creditors can do so. Second, to keep value inside the insolvent estate, and, in many jurisdictions, to even allow the insolvency administrator to increase that value by picking and executing just those open contracts which have a favourable value for the insolvent estate ('cherry picking'). The reasoning of this last element is to increase the amount available for sharing amongst all general creditors (on equal footing – *pro rata sharing*, or '*pari passu* principle').

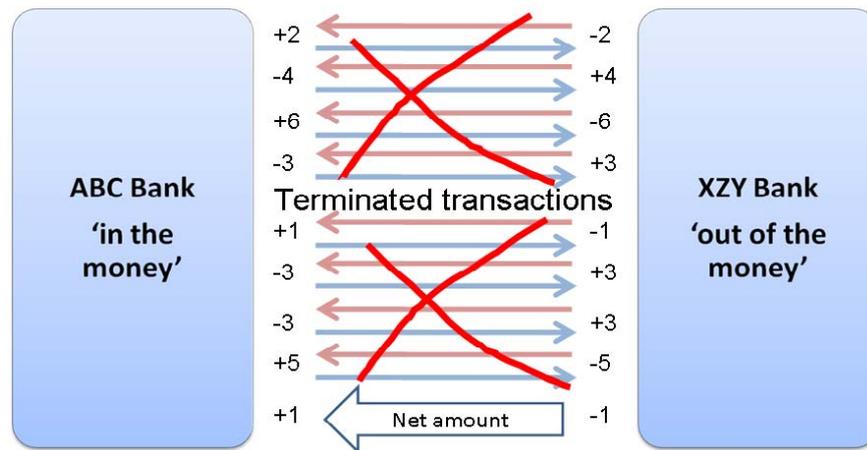
### ***The basic mechanisms of close-out netting***

However, there are a number of types of financial contracts, as well as some non-financial commercial contracts, which are understood to be of a special character in a sense that the 'automatic stay' of the insolvency law would do more harm than good. Therefore, in relation to these contracts, parties are allowed to circumvent the automatic insolvency stay by way of applying close-out netting between them, i.e., they are 'privileged' or 'have better priority', etc.

The purpose of close-out netting is to reduce risk exposures on open contracts if one party should become insolvent (or a similar event occurs) during the lifetime of the contract. The agreement typically provides that the other party can terminate all outstanding contracts between the parties, calculate the losses and gains on each contract and then set them off so that only a balance is owing, the 'net amount'. The calculated losses and gains usually are the difference between the agreed price of each transaction concerned and the market price at termination - essentially compensation for the termination calculated on damages principles.<sup>71</sup>

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<sup>71</sup> However, each jurisdiction uses a different technique to implement this mechanism into national law. It might be enshrined in the insolvency law itself as an exception to the generally applicable insolvency rules. It might also figure as a free standing provision in the banking code, etc. For a collection of examples of national rules cf. p. Paech, *The need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution*, Unidroit 2011, pp.22-27.

**Figure 5: The basic mechanism of close-out netting**

### Why close-out netting?

The contracts to which close-out netting applies are, roughly speaking, derivatives, repo-, securities lending- and margin lending transactions. Additionally, it applies to contracts for the sale and purchase of financial instruments (securities, money market instruments), currency and precious metals.

There are three main reasons for which such transactions are allowed the special treatment of close-out netting in case of insolvency of one of the parties.<sup>72</sup>

- These transactions comprise, from a legal perspective, two contracts. However, for the parties they form one 'transaction' from the outset. This is very clearly the case in relation to repo and securities lending transactions as well as in swap transactions.
- These contracts are usually dealt with *en bloc* from a risk management and capital requirements perspective. For example, if Party A and Party B have many mutual repos and securities lending transactions outstanding between them it is more efficient and cheaper to assess the relevant risk, post adequate collateral and calculate the necessary underlying capital if these legally distinct transactions are dealt with on an aggregate basis.
- These transactions are prone to carry risk that may become incalculable as soon as an insolvency stay applies and locks them in. In particular derivatives, but also repos and securities lending transactions, involve transferring assets to the other party. These assets are often volatile regarding their value. As long as both parties are healthy, risk management techniques, in particular the posting of sufficient collateral and subsequent 'margining', can keep that risk manageable. However, as soon as one party cannot participate any more in that risk adjustment process because all its open transactions are subject to an insolvency stay, the other party risks becoming heavily under-secured as soon as prices swing in one or the other direction. As this happens to all (!) counterparties of an insolvent financial institution at the same time (this is the general scenario after opening of the proceedings), all may suffer severe losses of the same kind, potentially triggering systemic consequences.

<sup>72</sup> Cf. for details Unidroit *Principles on the Operation of Close-out Netting Provisions* (2013), Key considerations regarding Principle 4.

### ***Risk reduction through close-out netting***

The Bank for International Settlements provides data<sup>73</sup> illustrating the effect of close-out netting in relation to the example of the derivatives market (the effects are comparable relation to the repo and securities lending market): the notional amount (face value) of all types of OTC contracts stood at approximately USD 639 trillion at the end of June 2012. The gross market value of these contracts, i.e., the cost of replacing all of them by equivalent contracts at the market price, was approximately USD 25 trillion. This amount corresponds to the gross market risk inherent in these contracts, i.e., market participants were, on an aggregate basis, exposed to each other by that sum. At the same time, market participants' aggregate actual credit exposures, i.e., the remaining credit risk taking into account legally enforceable netting agreements, amounted to USD 3.7 trillion, which represents a risk reduction of 85 %. According to the British Bankers' Association in a 2009 paper, its members even benefit from a reduction of exposure of between 95-97 %, on the assumption that enforceable netting agreements are in place.<sup>74</sup>

### ***Effect on capital requirements, collateral and liquidity***

Banking supervision has recognised the risk-reducing effect of close-out netting as capital requirements are calculated on the basis of 'net' rather than 'gross' exposure.<sup>75</sup> Furthermore, as a rule, collateral is provided on the basis of the 'net' exposure between the parties, thereby considerably reducing the cost of collateral.

As capital requirements for financial institutions decrease as soon as they apply a consistent netting policy, more capital is available for lending. Furthermore, as collateral provided between counterparties is calculated on the basis of net exposure, fewer assets (cash, securities) are blocked in collateral arrangements. Consequently, the widespread use of netting agreements in the financial market frees funds, which in turn increases overall market liquidity. Enforceable netting arrangements are therefore a factor pertinent to the competitiveness of individual banks and of entire financial market places.

### ***Systemic stability***

Systemic risk occurs where market participants are exposed to each other's failure in such a way that the inability of one financial market participant to meet its obligations when due will cause other participants to fail to meet their obligations when due. The use of close-out netting can prevent this risk of contagion from becoming systemic, i.e., from affecting the financial market to the point of becoming dysfunctional.

This is why the Cross-border Bank Resolution Group (CBRG) of the Basel Committee, in its 2010 report, included enforceable netting agreements in a list of mechanisms capable of mitigating systemic risk *in the first place*, along with collateralisation, segregation of client assets and standardisation and regulation of OTC derivatives. Consequently, it calls upon national authorities to promote the convergence of national rules governing the enforceability of netting agreements with respect to their scope of application and legal effects across borders.<sup>76</sup>

<sup>73</sup> Bank for International Settlements, Monetary and Economic Department, *OTC derivatives market activity in the first half of 2009*, November 2009, p. 1.

<sup>74</sup> British Bankers' Association, *Special Resolution Regime – BBA Response to HM Treasury Consultation Document*, p. 4.

<sup>75</sup> Bank for International Settlements/Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (Comprehensive version), June 2006, [bis.org/publ/bcbs128.htm](http://bis.org/publ/bcbs128.htm) ('Basel II Accord'), [117.], [118.], [139.], [188.]; *Strengthening the resilience of the banking sector*, (Consultative Document), December 2009, [bis.org/publ/bcbs164.pdf?noframes=1](http://bis.org/publ/bcbs164.pdf?noframes=1), p. 43.

<sup>76</sup> Basel Committee CBRG Report, Recommendation 8, p. 36 et seq.

### ***International status of close-out netting***

The theoretical option of using close-netting in the event of default of the counterparty must be backed by the certainty that it actually works when it comes to court proceedings.

Close-out netting is expressly recognised in about 40 jurisdictions. Within each of them there should be no major difficulties regarding enforceability of the agreement. However, in the cross-jurisdictional context, the contractual close-out netting provision agreed upon by the parties (usually contained in a master agreement, i.e. often English or New York law) might conflict with the (different) applicable national insolvency law. Such a conflict can render the close-out netting provision unenforceable, and the solvent party cannot benefit from its protection.

Given the systemic benefits of close-out netting, the EU Financial Collateral Directive protects close-out netting provisions to the extent they are entered into in connection with a collateral arrangement. I.e., close-out netting in relation to repos and securities lending is generally protected in the EU. However, there is agreement that some uncertainties remain.<sup>77</sup>

On the international scale, close-out netting is not harmonised and therefore faces heightened legal risk. This applies also to close-out netting provisions entered into by EU financial institutions with financial institutions from third countries, as the protection of the Financial Collateral Directive does not reach third country insolvency law. This is why the Member States of Unidroit have recently developed a set of benchmark principles on close-out netting.<sup>78</sup>

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<sup>77</sup> Cf. European Financial Markets Lawyers Group (EFMLG), *Protection for bilateral insolvency set-off and netting agreements under EC law*, October 2004, [15] and [111] in relation to EU law applicable outside the banking sector: the use of the term 'set-off' in the EU Insolvency Regulation and its subsequent divergent implementation in the EU Member States has created deep uncertainty as to whether the Directive's set-off protection (Article 6) encompasses elements that go beyond classical set-off, in particular close-out netting.

<sup>78</sup> Unidroit *Principles on the Operation of Close-out Netting Provisions* (2013).

## ANNEX 3 – REPOS ‘RECALLABLE AT ANY TIME’

This annex addresses an additional aspect of the assignment. We are requested to ‘examine if the fact that a transaction is “*recallable at any time*” should influence the level of minimum haircut or otherwise impact on the implementation of FSB recommendations’.<sup>79</sup>

### **Background**

Undertakings for Collective Investments in Transferable Securities (‘UCITS’) in general and money market funds in particular make extensive use of reverse repo arrangements (i.e., fund lends out cash and receives securities collateral), with some funds lending out all their cash on the terms of such agreements. Repo arrangements (i.e., fund borrows cash and posts securities collateral) are likely to be of great interest to funds which need to post cash collateral to clearing houses in the context of mandatory clearing of over-the-counter (‘OTC’) derivatives.

The relevant issue here is, that there are risks associated to the fact that assets (both cash and/or collateral) are not accessible for the UCITS fund for the duration of the contract. That may impinge on funds’ cash liquidity and redemption obligations (in the case of reverse repo entered by the fund), and on funds’ ability to access posted securities collateral in case of need (in the case of repo entered by the fund).

Against this background, ESMA has introduced<sup>80</sup> the following new rules with the document 2012/722, which became part of ESMA’s guidelines on ETFs and other UCITS issues of the 25 July 2012 (ESMA 2012/474).

*‘A UCITS that enters into a reverse repurchase agreement should ensure that it is able at any time to recall the full amount of cash or to terminate the reverse repurchase agreement on either an accrued basis or a mark-to-market basis. When the cash is recallable at any time on a mark-to-market basis, the mark-to-market value of the reverse repurchase agreement should be used for the calculation of the net asset value of the UCITS.*

*A UCITS that enters into a repurchase agreement should ensure that it is able at any time to recall any securities subject to the repurchase agreement or to terminate the repurchase agreement into which it has entered.*

*Fixed-term repurchase and reverse repurchase agreements that do not exceed seven days should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS.’*

The detailed rules on what exactly the fund can recall in the reverse repo setting (recalling the cash either on an accrued basis, typically only applicable to overnight arrangements, or on a mark-to-market basis, equivalent to the cost of unwinding the transaction) are the result of extensive input of the financial industry during ESMA’s consultation, cf. ESMA’s consultation page.<sup>81</sup>

<sup>79</sup> Cf. ESMA Guidelines on repurchase and reverse repurchase agreements of 4 December 2012 (ESMA 2012/722).

<sup>80</sup> There is already a very similar rule in respect of securities lending agreements contained in ESMA’s Guidelines on ETFs: ‘A UCITS should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.’ Concerns were raised that applying a similar rule to reverse repo arrangements would rule out the entering into of term repo and reverse repo arrangements. Hence the additional consultation by ESMA.

<sup>81</sup> <http://www.esma.europa.eu/consultation/Consultation-treatment-repurchase-and-reverse-repurchase-agreements#responses>.

## **Analysis**

The policy towards repo and securities lending transactions promoted by the FSB Work Stream 5 in its Consultative Document applies to *all* transactions regardless of whether or not they are callable at any time. In other words: callable repos are still 'normal' repos, just that the duration of the contract is determined by the notice given by the UCITS fund. Thus, any regulatory haircut imposed on repo and securities lending transactions as a consequence of implementing the FSB Recommendation 7 would in principle equally apply to UCITS fund collateral.

Should there be a reason for factoring in the fact that UCITS repos are callable at any time? In other words: should the regulatory haircut be in any way different from the one imposed on repos that are not callable at any time? This would only be justified if the trait of being callable posed any kind of additional risk to the UCITS, its counterparty or the market as a whole.

- UCITS funds have been provided with the option to recall their repos or reverse repos at any time with a view to protecting their liquidity vis-à-vis their investors. They have the option to recall if required for liquidity needs. Therefore, it seems unlikely that the UCITS fund is exposed to additional risks provoked by that option.
- The counterparty of the UCITS fund faces the situation that the UCITS may recall its assets before the repo transaction has reached its original maturity. Should the counterparty be unable to comply with the request of redelivering the relevant assets, the fund can terminate and close-out the transaction. Again, that situation is not different from the situation of parties entering into a 'normal', non-callable repo. Further, the market is used to this kind of 'open' repo, as about 5 % of repos and literally all securities lending transactions do not have a fix maturity date but end upon termination by one of the parties. Could a fund's counterparty get into difficulties in case the fund suddenly terminates a large number of repos? Of course the counterparties should be prepared to that situation. In addition, there are other mechanisms absorbing such difficulties (for example the intermediation or central clearing of the repo).
- As the parties do not face a risk specifically attached to that trait, there is no risk that could spread to the market as a whole. Anyway, about one third of all repos are of a very short-term (1 or 2 days) and are therefore subject to not being renewed after maturity. Therefore, we think that the market is well prepared to accommodate the requirement of 'callable at any time'.

There seems to be no risk specifically caused by the trait of being callable at any time.

## **Conclusion**

There seem to be no particular difficulties inherent in this issue. Also, the relevant ESMA and FSB documentation including answers from market participants does not point at this issue as being problematic.

# NOTES



DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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ISBN 978-92-823-4580-1

doi:10.2861/22838