EUROPEAN REPO COUNCIL

An update on reform of market infrastructure since the ERC White Paper of 13 July 2010

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1 Introduction

1.1 In July 2010, the ICMA's European Repo Council published "A white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure". Among other things, this document highlighted concerns among market users at the persistence of significant barriers to interconnectivity between the ICSDs and the domestic CSDs in Greece, Italy and Spain. These barriers undermine the efficiency of cross-border transfers of securities, fragment the European financial markets and exacerbated the impact of the recent crisis. They have remained in place despite many years of strenuous effort to create a single European financial market.

1.2 This latest document sets out the responses to the ERC White Paper from domestic CSDs and CCPs, and describes the progress that been made since July towards the elimination of barriers to interconnectivity.

1.3 In the case of Italy, long-standing concerns over obstacles to interconnectivity between the Italian CSD and the ICSDs were accentuated by a dramatic increase in delivery failures on transactions (mainly repos) cleared through the international CCP, LCH.Clearnet, in the first half of 2010. These peaked at almost 11% in May 2010. The problem appeared to coincide with the start of same-day transactions in CCP-guaranteed repos in November 2009 and was widely attributed to this initiative, although a number of market users argued that the surge in fails reflected market turbulence and short-selling by international investors, who mainly clear through LCH.Clearnet Ltd. Shaping sizes have since been harmonised at EUR 5 million (except for same-day CCP transactions). Since May 2010, there has been a significant reduction in delivery failures.

1.4 Recently, the Italian CSD has aired proposals for significant changes to the settlement system, in anticipation of the introduction of T2S in 2014, which could remove many of the current barriers to interconnectivity. Discussion between the CSD and its members are continuing.

1.5 There has been some progress in Spain (see section 3). Moreover, the interbank funding difficulties experienced by Spanish banks have led to the introduction of CCP services by LCH.Clearnet Ltd (albeit through an indirect route, given that foreign CCPs still do not have direct access to the CSD). MEFFClear is reorganising its CCP services and has experienced a revival in business. However, the introduction of CCP services by LCH Clearnet Ltd is reported to have been hampered by interconnectivity problems between the CSD and the ICSDs, as well as uncertainty about the fiscal requirements for the cross-border use of some Spanish securities.

1.6 For the time being, there is nothing substantive to report on Greece. However, discussions continue apace. A meeting with the primary dealers hosted by the Greek Debt Management Office in October 2010 discussed possible new measures to restart the government bond market. International market users expressed the wish to have further and in-depth discussions with the Greek authorities, and the EPDA and the ERC have been invited to a workshop with the

DMO and central bank in Athens currently scheduled for today (17th December). The workshop is intended to help forge a consensus on the nature of the challenges confronting the Greek market and provide an opportunity to identify possible solutions that can then be discussed with local custodian banks and primary dealers. Both the EPDA and ERC have expressed the hope that a constructive dialogue looking at all aspects of the government bond market in Greece will lead to substantial improvements in the functioning of that market.

1.7 The pace of reform of the market infrastructure in Europe is almost certain to accelerate in the near future with the advent of T2S and CCBM2, as well as new European regulatory initiatives. As regards regulation, proposals for a common framework for CSDs are scheduled to be announced by the European Commission next summer. Discussions have already started between the Commission, Member States and the market, and a public consultation will be launched in January 2011. The Commission has highlighted the need to address cross-border access to CSDs. The prospective changes will have a fundamental impact on the structure and operation of European CSDs, and present a fresh opportunity to eliminate the remaining barriers to interconnectivity between CSDs and ICSDs. A series of further updates will be published to track progress.

2 Italy

The following table sets out the concerns reported in the White Paper of July 2010, the response to those concerns at the time and the current situation.

<table>
<tr><th>issue</th><th>initial response</th><th>latest position</th></tr>
<tr><td>Once instructions are passed from the daytime batch-processing cycle into RTGS, they remain in RTGS and are not recycled into the batch-processing cycles. This tends to perpetuate fails, as RTGS lacks both:
• technical netting (the netting of opposite matching instructions, including unsettled instructions on the opening leg of a repo against the closing leg of the same transaction);
• a bilateral facility for users to fix delivery failures by mutually-agreed correction, amendment or cancelation of unsettled instructions.
As unsettled instructions in RTGS are then recycled for up to 10 days, credit exposures increase and buy-ins are delayed by up to a further 10 days, amplifying the cost of failing.</td><td>The CSD consulted members on the insertion of multiple daytime batch-processes and the recycling of instructions into RTGS above certain volume and value thresholds. However, it judged that such changes would not be cost-effective, given that only 1-2% of transactions settle in the daytime batch-processing and the CSD also initially cited the imminence of T2S (which was subsequently postponed until 2014).</td><td rowspan="2">No changes to date, but discussions are continuing on proposals for significant changes to the settlement system which have the potential to resolve these issues.</td></tr>
<tr><td>Local custodian banks require very early telephone pre-matching of settlement instructions.</td><td>• It was claimed that there are tools provided by the CSD that allow users to perform early matching of transactions by using segregated accounts (Conte Liquidatori) for each customer, but it was unclear whether this is a practical approach.
• The CSD consulted with members on the possible introduction of new matching facilities which would remove the prima facie need for telephone matching.</td></tr>
</table>

There was concern that the concentration of settlement in the overnight batch-processing cycle (96% by number of instructions, 80% by value) reflected the difficulties posed by RTGS.	The CSD argued that the concentration of settlement in the overnight batch-processing cycle was a sign of settlement efficiency.	
The lateness of settlement reports from the overnight batch-processing cycle gave users insufficient time to arrange re-use of their securities.	It was argued that a settlement report issued at 07:00 CET on settlement date (S) provided users with sufficient information to be able to arrange re-use of their securities. This deadline is apparently the time stated in the CSD user manual but the actual time of publication was 00:00 (CET). However, even this regarded by many users was too late.	
Late finality of the daytime batch-processing cycle (13:15 CET).		
Different shape sizes for CCP and OTC transactions.	The CSD has harmonised shaping at EUR 5 million for all CCP and OTC transactions, except same-day CCP transactions. It was estimated that harmonised shaping would reduce delivery failures by 30%.	
Access to the RTGS between 16:10 and 18:00 CET is reserved for local custodians.	The CSD clarified that late access was restricted to all direct participants/clearing members (not just local custodians) and argued that the cut-off time of 16:10 compared well with other settlement systems.	
An illiquid securities lending market.	Settlement difficulties in Italy would benefit from a securities lending facility within the CSD and a liquid securities lending market outside.	
Netting calculations are performed by the CSD, which passes the results to the CCPs. Concern was expressed about the blurring of functions between the CSD and CCPs,	It was suggested that this arrangement was merely a business convenience to allow the CSD to calculate charges for delivery failures. The CSD rejected the suggestion	The CSD has explained that the CCPs have merely outsourced settlement and payment netting calculations to the CSD, and that the

particularly as the migration of the CSD onto the Express II system in 2006 created problems which also affected the CCP.	that the new settlement system had caused these difficulties, which it attributed to cash and securities shortages among participants.	CCPs continue to perform risk netting calculations independently.

3 Spain

The CSD imposes penalties on members failing to deliver. Some market users believe that these penalties make members reluctant to trade with non-members, given that non-members are able to fail, as the members would be obliged to borrow in order to cover these fails, which could prove expensive. Current arrangements therefore ensure that delivery failures are minimised, but may have the effect of isolating the domestic market in Spanish government securities. The current arrangements also appear to be the reason behind restrictive practices such as barriers to foreign membership of the CSD and preferential access to the settlement process to members. The high rate of settlement efficiency that is being achieved may therefore have significant side-effects on cross-border investors.

The following table sets out the concerns reported in the White Paper of July 2010, the response to those concerns at the time and the current situation.

About 30% of settlement is concentrated between 13:00 and 13:30 CET, which constrains the ability of users to fix unsettled transactions or to re-use securities for same-day value. This problem is attributed in part to the practice of certain investment fund members of the CSD being unable to send instructions earlier in the settlement day due to timing issues relating to their cash positions.	The CSD suggested that the concentration of settlement is also due to the same-day trading of government securities during this period. It also maintained that the remaining 2-2½ hours of the settlement day and a last batch-processing at 16:45 CET is adequate to settle other transactions. The CSD and the ICSDs agreed to examine the issue together.	The CSD does not see the concentration of settlement between 13:00 and 13:30 as an issue, noting that 60% of daily settlement activity takes place in the overnight cycle and that members have two hours after 13:30 CET in which to resolve settlement issues. However, the present degree of concentration concerns some market users and is also at odds with best practice, which is to spread settlement activity as much as possible across the whole settlement day in order to avoid the concentration of possible problems and maximise the time for problems to be resolved. The CSD recently extended the deadline for the communication of same-day transactions and believes that this will dilute the current concentration.
The finality of the overnight batch-processing cycle, which ends at 20:00 on	The CSD announced in October 2009 that, following agreement by the	Resolved.

S-1, was delayed until 07:00 CET on S. This was seen as very late and representing a constraint on the re-use of securities.	authorities, finality was to be advanced to 00:00 CET.	
Members of the CSD are prohibited from failing to deliver. This makes them reluctant to trade with non-members (who can fail), given that the members would be obliged to borrow in order to cover delivery failures by non-members, which could prove expensive. Market users expressed concern that the particular mechanism used in Spain, while very efficient for domestic users, has fragmented the market by discouraging business with cross-border counterparties. Such a side-effect is very undesirable, as it represents a hidden barrier to the Single Market.	The CSD argues that there is no such prohibition. Rather, members are subject to a "strict settlement discipline mechanism aimed at avoiding settlement failures as much as possible" which is "composed of an end-of-day loan system by which those entities not delivering securities on intended settlement date will be subject to an automatic overnight repo in order to deliver the securities. The second measure is the penalties regime by which those entities failing to deliver will be subject to a penalty."	The CSD has re-stated its policy that failure to deliver securities is not allowed for any market user, whether a member of the CSD or not. It has noted that, in the case of its members, it covers any end-of-day short position, whether they arise across a member's own account or across that member's client accounts, and applies a penalty. In the case of delivery failures by non-members, it is up to custodians. Custodians are able to: • Use a hold and release mechanism at the CSD to pre-match their clients' settlement instructions and hold back these instructions until it is certain that clients have sufficient securities in their accounts. • Pass on to clients failing to deliver to the custodians all the costs and penalties imposed by the CSD on the custodian because of that failure. The CSD notes that the current model has achieved settlement efficiency nearly 100%. It argues that such efficiency is valued by the market and opposes any changes that would impair its efficiency.
Between 15:30 and 16:00 CET, access to the settlement process is restricted to	The CSD stressed that the constraint was limited to communication only, as pending	The extension of the deadline for third-party instructions into RTGS to 16:00

users with their own accounts at the CSD settling their own transactions and excludes third-party users. The exclusive own-account window is seen as a consequence of the prohibition on members of the CSD failing.	third-party trades could settle during this period, as well as in the last batch around 16:45 CET. It also questioned the significance of the issue, suggested that the problem was due to ICSD processes and initially claimed that the required technical changes to open access to all users were too expensive to contemplate and unjustified given the imminence of T2S. The ICSDs argued that the issue was significant, claiming that 15% of transactions remained unsettled at 14:30 CET and 10% at 16:45 CET. In October 2009, the CSD decided that the settlement system was flexible enough to permit reasonable exceptions upon request. It has also declared itself willing to consider alternatives, including further narrowing of the exclusion period, but has ruled out elimination because of system requirements. The CSD and the ICSDs agreed to discuss the issue. In November 2009, the CSD extended the deadline for third-party instructions to 16:00 and own-account members to 16:15.	(from 15:30) and for own-account members to 16:15 (from 16:00) represents significant progress, but still excludes third-party users for 15 minutes. The CSD believe that 15 minutes is negligible and no longer an issue. Some market users disagree and a number believe that there is also an important matter of principle here.
The prohibition on members of the CSD failing also necessitates a special fails management window at the end of the daylight settlement cycle, which might be better used to extend the first cycle.		The CSD stress that this window is usually open for no longer than 10 minutes, out of an overall period of 9 hours, and argue that it is therefore insignificant. No progress.
The only foreign institutions able to open third-party or omnibus accounts at the CSD are foreign CSDs. Non-CSD foreign participants can only open own accounts.	The CSD claims that opening access to other market users would require a change in national law and it was agreed to revive this issue when proposals for EU	No change in the law is expected in the near future.

This compels foreign users to use domestic settlement agents.	securities law reform are made.	
It was not possible for other CCPs, such as LCH.Clearnet or Eurex Clearing, to clear Spanish government securities because they are not allowed access to the CSD.		• The CSD reports its governing regulations have been changed to allow all CCPs and ATS/MTFs to open accounts at the CSD. • LCH.Clearnet Ltd started to clear Spanish government bonds in August 2010 in response to urgent market demand following the interbank funding difficulties experienced by Spanish banks. LCH.Clearnet Ltd settles at the ICSDs. LCH.Clearnet SA plan to launch a second clearing service in December 2010 using a custodian bank which is a member of the domestic CSD. However, LCH.Clearnet Ltd has encountered a tax obstacle in clearing Spanish treasury bills with a term longer than 12 months. Where these securities are settled outside the domestic CSD, one ICSD believes that there are mandatory reporting requirements (about the identity of the beneficial owner) that are regarded as sufficiently onerous for that ICSD to refuse to settle these securities, which has led to them being excluded from electronic trading. There is a difference of opinion between the ICSDs on the reporting requirement and they are continuing to investigate the problem. • The clearing service operated by LCH Clearnet Ltd is also reported to have

		been hampered by delays in instructions for the cross-border movement of Spanish securities being settled until after the deadlines for new instructions (16:00 CET for members and earlier for clients), preventing re-use of securities. • The funding difficulties experienced by Spanish banks have also led to renewed interest in the domestic CCP, which is re-organising itself and adapting its business model to align more closely with market preferences and new European legislation.

In the ERC White Paper, it was noted that the only CCP that was clearing Spanish government securities was MEFFClear. The White Paper reported the concern that MEFFClear would withdraw from clearing in the event of a default by a member, leaving other members to cover the loss. In other words, the CCP would cease to be a CCP in the event of a default. However, at the time of publication of the White Paper, little information was available about the operation of the CCP. After further investigation and discussion with MEFFClear, it is clear that this statement was incorrect. The author apologises unreservedly for the misunderstanding. It is now possible to clarify how the CCP operates:

- In the event of default by a client of a member, the member would be solely responsible for any loss resulting from the closing out of the client's position.
- In the event of a default by a member, the CCP would not call upon other members. Instead, resort would be made to the initial margin posted by the defaulting member and then "individual clearing funds" (a fixed sum of collateral posted by each member and called the "General Guarantee"; currently, a minimum EUR 3 million for members clearing only for themselves).
- Should the losses created by the default of a member exceed its individual clearing fund, no call would be made on the individual clearing funds of other members. Instead, resort would have to be made to the equity of MEFFClear.
- The CCP does not currently maintain a mutual default fund (ie a fund subscribed by all members to absorb losses created by the default of any one of them above initial margin). However, in anticipation of new EU legislation, such a fund is to be introduced in parallel with changes to the structure of MEFF, which will see MEFF Renta Variable taking over the repo activity of MEFF Renta Fija, under the name MEFF. In addition, a share of MEFF's equity will be carved out to form the MEFF Fund. The mutual default fund and the MEFF Fund will be divided by market segment (repo, equity derivatives and energy derivatives). The basic MEFF default waterfall will be: (1) defaulting member's initial margin; (2) defaulting member's contribution to the new

mutual default fund; (3) defaulting member's individual clearing fund; (4) the MEFF Fund for the segment suffering the default; (5) the rest of the default fund for the segment suffering the default; (6) MEFF equity. Step (5) will therefore be the first direct mutual exposure of non-defaulting members to a default.

- The CCP currently does not perform multilateral netting between its members. In this, it differs fundamentally from the majority of other CCPs. Indeed, MEFFClear is not a central clearing counterparty. Rather, it is just a central counterparty (that guarantees transactions). However, multilateral netting will be introduced in the first half of 2011, transforming MEFFClear into a true central clearing counterparty.
- MEFF believes the transfer of repo operations from MEFF RF to MEFF RV will attract foreign banks by broadening membership and widening the range of asset classes covered by its central counterparty service. The first foreign bank has joined recently.
- Volumes being cleared by MEFFClear have picked up sharply in 2010, following the funding difficulties experienced by Spanish banks.