MONEY MARKET FUNDS AND REPO CLEARING

OVERVIEW

The European Union (EU) is an international financial centre for many funds, including money market funds (MMFs) that are invested into foreign assets denominated in currencies other than the euro (EUR).

The success of EU-domiciled MMFs depends on the depth and breadth of the funding market to which they have access to. As part of this, many EU MMFs enter into government bond reverse repo transactions, including cleared reverse repo transactions, to earn a return on the cash they have available. This is an important role that EU MMFs provide in their capacity as cash and liquidity providers, particularly in times of stress.

However, post Brexit, EU MMFs can no longer enter into cleared gilt reverse repo transactions with LCH Ltd without a haircut being applied. This is because the Securitisation regulation requires EU MMFs to apply a haircut to assets received under a cleared reverse repo transaction, unless the central counterparty is ‘authorised’ under EMIR. This does not include third country central counterparties (TC CCPs) that are ‘recognised’ under EMIR and therefore LCH Ltd is excluded from this exemption post Brexit.

Since EU-domiciled CCPs do not offer adequate liquidity for non-EUR denominated repo and reverse repo transactions there is a strong desire for EU MMFs to transact with TC CCPs for non-EUR reverse repo transactions. However, the requirement to apply haircuts for reverse repo transactions cleared via TC CCPs prevents these trades from taking place and instead encourages the use of bilateral trades, as explained below. While we do support bilateral repo transactions, we believe that cleared repo transactions should also be equally supported.

SUPPORTING REPO CLEARING WITHOUT HAIRCUTS

Why must haircuts apply if EU MMF trades reverse repo with TC CCPs?

Article 2(2) of the European Commission’s Delegated Regulation EU 2018/990 of 10 April 2018 states that any EU money market fund entering into a reverse repo transaction will be subject to a haircut unless it transacts with a counterparty listed in Article 2(6) of the same regulation.

Article 2(6) includes both EU and third-country banks and investment firms, so long as the regime is deemed to be equivalent by the EU. However, the language in Article 2(6) only includes CCPs that are ‘authorised’ in the EU and does not include third-country central counterparties that are ‘recognised’ by the EU. Therefore, MMFs entering into reverse repo transactions will require haircuts to be applied when cleared with a TC CCP even if it is ‘recognised’ by ESMA in accordance with EMIR 2.2.

Can an EU MMF transact reverse repo cleared with an EU CCP?

Liquidity for non-EUR repo transactions does not reside with EU CCPs, as non-EUR repo transactions are mostly cleared through TC CCPs.

Why are haircuts problematic on these transactions?

Assuming that haircuts were to apply for a cleared reverse repo transaction between an EU MMF and TC CCPs, the EU MMF would need to, for example, receive government bonds with a value of 103 from the CCP in order to lend only 100 in cash to the TC CCP. Note that the haircut would need to be posted by the CCP to the EU MMF and not the other way around.

Below are a number of reasons why this results in these trades not taking place:

- CCPs are not set up, nor need to, post or receive haircuts on cleared repo transactions since CCPs manage counterparty credit risk by requiring initial margin and default fund contributions to be posted to it.
- If in theory haircuts could be applied to cleared repos, then the execution broker would need to pay this haircut to the CCP (which in turn would be passed to the EU MMF), and the EU MMF would need to compensate the execution broker for any additional costs.
resulting from this. This would make a cleared reverse repo transaction uneconomical when compared to a bilateral transaction once the cost of haircuts, initial margin and default fund contributions are factored in.

- Operationally any over-collateralisation in the form of haircuts posted by the execution broker to the CCP will usually be returned the next day as part of the CCP’s normal operations so this would not practically work for any reverse repos with maturities longer than overnight.

- Finally, it must also be noted that an execution broker would be unwilling to pay haircuts to CCPs on a cleared repo transaction. This is because all market participants trade cleared repos without haircuts being applied, so even if in theory an execution broker could enter into a cleared repo transaction and paid a haircut to a CCP, the execution broker would not receive that haircut back from another bank if they then executed an offsetting cleared repo transaction with another bank.

Why is it in the EU’s interest to resolve this?

We believe the above is an unintentional consequence possibly stemming from the fact that EMIR 2.2 had not concluded when the Commission’s delegation regulation EU 2018/990 was agreed. We are not aware of EU regulation differentiating between CCPs authorised and recognised under EMIR.

An important parallel can be drawn with the capital requirements under CRD/CRR where the same treatment is ensured when facing CCPs whether these are authorised or recognised under EMIR (for example Article 4(1)(88) of Regulation (EU) No 575/2013 defines ‘qualifying central counterparty’ or ‘QCCP’ as a central counterparty that has been either authorised in accordance with Article 14 of Regulation (EU) No 648/2012 or recognised in accordance with Article 25 of that Regulation). This complements the view that the counterparty credit risk for a recognised CCP should be similar to that of an authorised CCP such that differing haircut treatments should not be required. We have not found any justification in the Commission’s delegation regulation EU 2018/990 to explain the difference of treatment.

We would note the importance that all EU MMFs have access to central clearing in both EUR and non-EUR liquidity, particularly GBP denominated gilt reverse repo transactions with TC CCPs. Access to cleared liquidity pools increases EU MMFs’ operational investment resilience, and further strengthens their role as cash and liquidity providers in the EU market.

The following chart shows the international nature of EU MMFs in term of the composition of its asset. As such, we encourage the EU in its role as a world-leading fund location to support all EU funds, even those that are invested into foreign assets.

Source: EFAMA Market Insights Issue 2 October 2020; link found here.

How can the problem be solved?

Recommendation: We kindly request the European Commission considers the below change to Article 2(6) of Commission’s delegated regulation EU 2018/990 as follows:

Paragraphs 1 to 5 shall not apply if the counterparty to the reverse repurchase agreement is any of the following:

(a) a credit institution supervised under Directive 2013/36/EU of the European Parliament and of the Council, or a credit institution authorised in a third country, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the Union;

(b) an investment firm supervised under Directive 2014/65/EU of the European Parliament and of the Council, or a third country investment firm, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the Union;

(c) an insurance undertaking supervised under Directive 2009/138/EC of the European Parliament and of the Council, or a third country insurance undertaking, provided that the prudential supervisory and regulatory requirements are equivalent to those applied in the Union;
(d) a central counterparty authorised or recognised under Regulation (EU) No 648/2012 of the European Parliament and of the Council;

(e) the European Central Bank;

(f) a national central bank;

(g) a third country central bank, provided that the prudential supervisory and regulatory requirements applied in that country have been recognised as equivalent to those applied in the Union in accordance with Article 114(7) of Regulation (EU) No 575/2013.

CONCLUSION

We would welcome the opportunity to discuss the above issues.