FIA response to the Bank of England Discussion Paper on Enhancing the resilience of the gilt repo market

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Sent via email to GiltreporesilienceDP@bankofengland.co.uk

1. Introduction & Executive Summary

FIA[1] welcomes the opportunity to respond to the Bank of England Discussion Paper on Enhancing the resilience of the gilt repo market ('Discussion Paper' or 'DP').

While we have discussed the Discussion Paper with different market participants, the feedback in our response represents the views of FIA clearing members.

We believe that the initial discussion on this important topic should be based upon what the Bank of England is trying to solve for. We would welcome further insights into Bank of England's concerns and motivation for this work and whether it is driven to find solutions to gilt volatility, market liquidity resilience, credit and leverage or something else.

Overall, FIA clearing members' preference is to focus on incentives for more voluntary clearing of gilt repos and organic growth of this market, rather than a clearing mandate, which we do not currently support. Our clearing members are also not supportive of introducing mandatory minimum haircuts for gilt repos. Haircuts cannot be viewed in isolation. Instead, a more holistic view should be taken, including a consideration of whether other risk management practices are being utilised (e.g. portfolio margining / netting). As a result, we suggest a more holistic analysis is carried out before any policy proposals are put forward.

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA's mission is to:
- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

Should the Bank of England choose to move forward with any of the proposals raised in this discussion paper, further consideration will be required as to their scope and application, including the population of firms that would be impacted, and how any requirements would apply on an extraterritorial basis. This is critical to determine whether the proposals would have the desired impact, and/or create unintended consequences.

Furthermore, we would encourage the Bank of England to look at the longer term structure of the market and consider how innovation like the development of the digital gilt could address some of the points mentioned in the discussion paper (e.g. counterparty credit risk and improving operational efficiency) and may represent an alternative way of achieving the benefits of central clearing via other means.

Finally, we note the broader Government's Financial Services Growth and Competitiveness Strategy and believe that any novel regulatory proposals concerning the gilt repo market that result in burdensome implementation for market participants need to be assessed through that lens as well.

2. <u>Central clearing</u>

As mentioned in the introduction, FIA clearing members do not support a clearing mandate for gilt repo transactions. We have set out key reasons for this view below.

Instead, we advocate for market-led voluntary clearing of gilt repos, an improvement of the current CCP offering and a removal of regulatory barriers that prevent or make it difficult for market participants to clear gilt repo transactions.

Should the Bank of England nevertheless choose to move forward with the clearing mandate for gilt repo transactions, any final policy proposal should ideally come only after the US Treasury (UST) clearing mandate has gone live in the US, so that the private and public sectors can both benefit from the US experience and avoid overlapping implementation. The UST clearing mandate was first proposed in September 2022 and the rule was finalised in December 2023. It is scheduled to go live at the end of June 2027 for UST repo clearing. During this period policymakers and market participants have been engaged in an extensive implementation program, including regarding refinements to the structure of the mandate itself, the requisite market infrastructure, access models, documentation, capital and accounting treatment, among other topics. Although the UST and UK gilt markets have some important structural differences, there are already some 'lessons learnt' in the lead up to the UST clearing mandate that should be considered in the UK context, as detailed below. Further information will be available on the market impact of the clearing mandate once it goes live.

We note that the UK has recently permanently extended the exemption for pension funds to mandatorily clear certain derivatives contracts at a CCP. It is not immediately clear from the Discussion Paper as to which counterparties would be subject to clearing of gilt repos in the UK, but assuming that pension funds and the Bank of England would be out of scope of the potential mandate, this would exempt a significant segment of the gilt repo market from clearing.

a. ***Gilt repo market structure***

- **UK market**
    - We agree with the Bank of England's statement that the majority of interdealer gilt repos are voluntarily centrally cleared. Central clearing rates are high (around 23% of the overall gilt repo market). In other words, a lot of what can be cleared at the moment is already being cleared voluntarily (i.e., in the interdealer market).

    - However, we understand that non-bank financial intermediaries (NBFIs) are becoming increasingly fundamental to how the gilt repo market operates. The structure of the gilt market has shifted such that hedge funds and other NBFI participants primarily buy long-dated gilts from pension funds[2] (marginal buyers of gilts).

    - An important function of the repo market in the UK is maturity transformation. This is more difficult to achieve in the context of central clearing due to the additional margin exposure of transacting term. As a result, it will be more costly to clear long dated gilt repos used for maturity transformation. We note that NBFIs are entering into gilt repo transactions with longer-dated tenors that are more costly to clear. Maturity transformation in the gilt repo markets means that netting benefits will be less significant than for the U.S. Treasury market.

      Due to differences between UK and US government debt market structures, netting efficiencies and netting capacity impacts may not be so great for the UK with the UK market being focused more on collateral/maturity transformation and the US market focused more on overnight liquidity. Maturity matching is a key component for achieving balance sheet netting and capital efficiency for banks under key prudential metrics. Therefore, as the Bank of England considers this matter further, it is important that it takes into account the differences between the UK and US government debt markets to make sure that the assumptions around the level of netting benefits from central clearing, which will form an important point in decision-making on future policy, are correct. In doing so, the Bank of England should also consider the extent to which mandatory clearing would reduce market resilience as the incentive to maximise netting benefit could increase participants' preference for overnight maturities.

- To incentivise more voluntary clearing of gilt repos and to address concerns around liquidity and market resilience, the Bank of England could explore whether it can participate in central clearing of these transactions similar to the recent announcement by the European Central Bank[3].

- **UK CCP limitations**
  - There is currently only one CCP that clears gilt repos. In other words, that CCP has a 100% share in the cleared gilt repo market today. Any proposal to introduce a clearing mandate for gilt repos in the UK needs to take into consideration the fact that only one CCP currently clears these transactions. This would create significant operational dependency on a single CCP.

  - We also note that gilt futures are currently cleared at a different UK CCP than gilt repos. No cross-product margining is currently possible between these two products cleared at two UK CCPs. Please see point *b.* below for more detail on this point.

- **CCP clearing model and clearing access**
  - While central clearing has the benefits for market participants that the Bank of England outlines in the Discussion Paper, the current clearing model for gilt repos is restrictive in terms of customer access and scalability.

  - Before further thought is given to a possible clearing mandate for clearing repos, which we do not think is the right next step, the public and private sector will need to work on developing an easily accessible clearing model for clients that wish to clear gilt repos and ensure that the provision of clearing services for gilt repos is economically viable for all parties involved.

  - Introduction of a new client clearing model for gilt repos would require a detailed review and analysis of its accounting treatment for clearing firms, as well as risk management and default management practices that would apply to such new model.

[3] European Central Bank to join Eurex Repo market and The European Central Bank joins LCH RepoClear SA | LSEG

- Overall, we believe that clearing models for gilt repo clearing need to strike the right balance between capital treatment, accounting treatment, default fund mutualization, margins, etc.

b. ***Cross-margining and cross-product netting***

In broad terms, under cross-margining programmes, market participants are permitted to post initial margin to CCPs based on the aggregate reduced net risk of a portfolio containing multiple products, including related repo and cash securities transactions, options transactions and futures contracts. Notably, the clearing member's aggregate initial margin requirement on a portfolio of eligible cleared trades may be reduced to the extent there are positions with offsetting risks, as determined under the applicable methodologies of the relevant CCPs.[4]

The ability to cross margin between gilt futures and gilt repos is an important consideration for clearing firms active in this market and those who are contemplating to enter it as clearing of gilt repos needs to be economically efficient. In the UK, this would need to take place across two CCPs (ICE Clear Europe for gilt repo futures and LCH Ltd RepoClear for gilt repos). The current UK regulatory framework for CCPs does not envisage cross margining between two CCPs.[5] Further thinking will need to be given as to how a cross-product margining arrangement would work, what it would mean for the CCPs, the clearing members and other market participants, and how it would be implemented.

In the US, the discussions on this matter are more advanced with some cross-margining arrangements between cash and futures products already available for direct participants of relevant CCPs and others still being discussed, including provision of cross margining for clients. According to estimates, these offsets could generate margin efficiencies of up to 80% in the U.S. context, providing a potentially meaningful offset to the other financial resource impacts associated with a central clearing mandate.[6] Such offsets are not currently available in the UK context.

It is important to note that to achieve economic efficiencies for clearing of gilt repos and related transactions such as gilt futures, recognition of cross-product netting under the bank capital framework is needed in addition to robust and risk-appropriate cross-margining at the CCP level. The industry has been advocating for changes to the US prudential regime to ensure that cross-product netting across derivatives and repo transactions under the standardized approach for counterparty credit risk (SA-CCR) calculation and other relevant capital metrics is recognised.[7] The same issue will need to be further explored in the UK context and under the UK capital requirements. Without

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[4] https://www.isda.org/a/B4YgE/Cross-product-Netting-Under-the-US-Regulatory-Capital-Framework.pdf

[5] We note the cautious comments on cross-margining arrangements between two CCPs that Sarah Breeden, Deputy Governor for Financial Stability of the Bank of England made in a speech earlier this year. Sarah Breeden: A system-wide approach to system-wide resilience - CCPs and their users

[6] https://www.cmegroup.com/solutions/clearing/cme-ficc-cross-margin-program.html

[7] https://www.isda.org/a/B4YgE/Cross-product-Netting-Under-the-US-Regulatory-Capital-Framework.pdf

the ability to net across products in the bank capital regime, any margin efficiencies generated through CCP cross-margining would not necessarily flow through to clearing members and therefore to end-users.

c. ***Cost implications***

When considering the introduction of a clearing mandate for gilt repos, or a significantly expanded role for central clearing through heightened incentives, one cannot avoid the question of costs, how those will be borne in the market, and how such costs would impact the liquidity and efficiency of the gilt market, and ultimately funding costs for the UK government.

Centrally cleared repo generates additional costs for market participants in comparison to uncleared activity, including due to initial margin[8], default fund contributions for direct members, various charges at the level of the clearing member and CCP, and operational and implementation costs. These not insignificant costs could act as a barrier to participate in this market as a clearing service provider and limit broader adoption. It is important to ensure that firms have incentives to offer the service of clearing of gilt repos and that it is relatively easy for clients/end-users to access it.

If NBFI/hedge fund costs of doing business increase meaningfully, that could change their business model and/or hurdle rates for their trading strategies, which could cause them to reduce their activity or change trading strategies until they can readjust to make equivalent return (i.e. greater discrepancies in yields from which they can generate greater returns to cover clearing costs). This could lead to implications to smooth functioning of the cash market, given how important NBFIs are now in that market and the close interconnectedness between cash market liquidity and the repo market.

The client side of repo clearing in the UK is not very well developed. If clearing members had to clear for NBFI/hedge fund clients, implementation costs would be significant. The build out of suitable clearing models for end-users in the UST mandate has been a significant, multi-year, industry-wide project.

d. ***Initial margin***

If clearing of gilt repos was mandatory, initial margin add-ons would impact liquidity in the repo market as directional users (i.e. large lenders of cash) would be capped on how much they could lend as it would become un-economical.

e. ***Central Bank Facilities***

Central bank facilities are now a significant part of the repo market. The inability to clear central bank facility drawings reduces the already low opportunities for netting.

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[8] FICC has previously estimated an additional $58.4bn in margin on the UST clearing side, of which half would be for indirect participants (i.e., end users). FIA has not confirmed with FICC if this number is still valid. [US. Treasury Clearing Industry Mandate Survey | DTCC]

f. ***Alternative products***

There is a risk that any mandatory push into clearing for gilt repos could change 'behaviour' of market participants such that they would enter into proxy repo instruments such as Total Return Swaps (TRS), which may offer lower running costs but introduce leverage in a different place in the market.

g. ***Sectoral impact***

Certain sectors (e.g., Money Market Funds, Pension Funds) are already subject to stringent leverage regulations. Additional costs may disproportionately penalise these participants without materially reducing systemic risk.

h. ***UK bank levy***

We also wanted to highlight the impact of the UK Bank levy which is applied to inbound branch banks on UK sovereign repo activity. We note the Bank of England's comments in Section 2.1 of the DP acknowledging the critical role played by dealers in maintaining financial stability within the banking sector. However, the bank levy rules as currently drafted remain at odds with this in that they effectively constrain a UK branch bank from providing liquidity by penalizing them with a bank levy cost for conducting this activity as repos on gilts are not deducted from the basis of calculation in place for overseas banks trading in the UK[9]. We would strongly recommend that this impediment is removed. We draw the Bank of England's attention to the fact that the same bank levy disincentive exists for branches that conduct UK client clearing businesses.

i. Digital gilt

In light of the UK Government's initiative to develop a digital gilt (DIGIT), we believe it would be prudent for the Bank of England to consider to what extent the development of DIGIT could help address some of the risks that it has identified in the discussion paper. For example, whether DIGIT could help to achieve some of the same goals as central clearing (e.g. reduced counterparty credit risk, operational efficiency etc) but in a different way.

In this regard, we believe any future policy changes should take into account innovation in the market and avoid making short term changes which may be suited to the current state of the market but which may not be sufficiently future proof.

3. Minimum haircuts[10]

We believe that haircuts cannot be viewed in isolation. Instead, a more holistic view should be taken, including a consideration of whether other risk management practices

[9] For UK-based banks and subsidiaries of overseas banks, gilt repos are removed from the calculation of Bank Levy.

[10] FIA supports the views in the recent ICMA paper on the role of repo haircuts. In particular, we share the view that haircuts for repo transactions are not the correct tool for addressing (excessive) leverage in the NBFI sector. ICMA-ERCC-white-paper-Demystifying-Repo-Haircuts-September-2025-180925.pdf

are being utilised (e.g. portfolio margining / netting). Please see our other comments on minimum haircuts below.

a. **Alignment Challenges**
   Harmonising minimum haircuts with CCP margining models is complex due to dynamic nature of CCP haircuts.

b. **Risk Offsetting**
   Minimum haircuts may not reduce systemic risk if participants maintain offsetting positions, potentially increasing gross exposures under cross-product margining frameworks.

c. **Market Impact**
   Introducing minimum haircuts would involve a trade-off with increase funding costs, which in turn could dampen demand for long-dated bonds, where the cost of carry is already high. Central clearing of gilt repos for buys-side participants would result in more netting opportunities for banks that could help reduce balance sheet costs and the costs of margin.

d. **Pass-Through Costs**
   Higher margining costs will likely be passed on to end consumers, widening bid-offer spreads and increasing transaction costs.

4. <u>Alternatives</u>

FIA clearing members are of the view that the transparency and reporting requirements set out in the UK Securities Financing Transactions Regulation (UK SFTR) are sufficient and that additional public disclosures are not required at this point. If the Bank of England is of the view that current reporting under UK SFTR is not sufficient, we would welcome further detail and proposed specific changes that it would like to introduce in this area subject to a detailed cost-benefit analysis.

We note that the Bank of England in paragraph 76 suggests developing and adopting all-to-all trading platforms as a potential alternative measure to increase market capacity for gilt repo lending in stress scenarios.

We believe that all-to-all trading is unsuited for this market, as many market participants are not able to interact directly on the venue and favour bilateral trading. The illiquidity of UK gilt markets – characteristic of sovereign debt markets where bonds are often held to maturity and off-the-run issues trade infrequently – means all-to-all trading may not generate sufficient offsetting interest to maintain orderly markets, exacerbating price volatility and hindering efficient price discovery during times of stress.

It is also important to preserve choice in protocols for trading. Clients trading in larger sizes or more customised products often prefer RFQ as a way to reduce information leakage, and regulation should not force the market into a different option.

5. Miscellaneous

We note that some statements in the Discussion Paper would benefit from further discussion. For example, in the case of Australia and their approach to clearing of government debt that the Discussion Paper references, we understand that the public consultation has now closed and that they have reached the conclusion that there is not a compelling case for mandating central clearing in Australia at this time.[11]

FIA would be happy to engage in further discussions with the Bank of England on this topic and is ready to discuss the content of our response in more detail. Please contact Mitja Siraj, Vice President, Legal, Europe at FIA if you have any questions regarding this response.

[11] https://www.cfr.gov.au/publications/consultations/2025/reassessing-the-case-for-central-clearing-of-bonds-and-repos-in-australia/