

EFMLG Statement on Repo Regimes in Europe
--

Introduction	1
I. Survey of the European Directives referring to repo transactions	4
II. The scope of the harmonisation	8
III. Tax and accounting treatment	9
IV. The adequate instrument to harmonise repo regime	10
Conclusion.....	11

Introduction

The EFMLG Questionnaire relating to the legal, tax and accounting regime of repos in Europe (incorporating answers provided for each country by the members of EFMLG together with the synthesis of the such study) show that it seems advisable to harmonise repo legislation within the E.U. in a single legal act.

As decided during the EFMLG's February 2002 meeting, the statement was drafted to express the EFLMG's view that increased harmonisation of the regime of repos in Europe should be aimed for.

Such an harmonisation would need to ensure the following elements which are necessary to ensure legal certainty and the minimal standardisation required for the European internal repo market to grow :

- **A definition of repo transactions.** As shown further, although existing European rules contemplate or define repos, it appears that the legal characterisation of repos is not sufficiently achieved.
- **The enforceability of repo transactions against third parties.** Some disparities with respect to the repo characterisation still exist and therefore can give rise to legal risk, i.e. re-characterisation [potentially leading to the loss of all rights on the securities held]. Recognition of the full transfer of ownership of the underlying securities of the repo should be ensured in order for the European repo market to be fully efficient.
- **The recognition of the validity and the enforceability of close-out-netting.** An harmonisation of repo legal regime implies recognition of bilateral close-out-netting.
- **Tax and accounting neutrality.** A note covering tax and accounting problems raised throughout Europe by repo transactions was circulated to the EFLMG on February 18th, 2002 and is attached along with a 13 May 2002 document comparing the relevant EU directive with the various national situations. Even though neutrality in respect of tax and accounting treatment of repos is applied in a majority of member states, unanimous treatment in accordance with existing rules (accounting Directive, IAS rules...) remains necessary.

➤ **Does the Common Position adopted by the Council with a view to the adoption of the Directive of the European Parliament and of the Council on Financial Collateral Arrangements dated as of February 26, 2002 (hereafter "the Draft Collateral Directive") provide enough security and harmonisation of repo regimes ?**

The working group has studied the Draft Collateral Directive and concluded that it is intended to cover repo transactions. Indeed, three sections of the preamble refer to repo transactions :

- Paragraph three (3) includes repos when it recommends the creation of a community regime for "the provision of securities and cash as collateral under both security interest and title transfer";
- Paragraph thirteen (13) refers to the transfer of the full ownership of financial collateral and intends to avoid "recharacterisation" of such financial collateral arrangements (including repos) as security interest ;
- Paragraph fourteen (14) covers repo transactions when it requires enforceability of bilateral close-out-netting with respect to financial collateral arrangements.

Two of the four points mentioned in the foregoing paragraphs of the present document are thus taken into consideration by the Draft Collateral Directive, which aims to characterise repo transactions as collateral agreements by means of full transfer of ownership.

The Draft Collateral Directive may however have only a limited impact on repos as the Member States remain free to exclude *corporates* from its field of application.

Furthermore, unlike the previous drafts, the common position for the Draft Collateral Directive contains no definition while a harmonised regime of repos requires an uniform definition.

Therefore the EFLMG, being aware of the foregoing considerations and convinced of the necessity of the harmonisation of the repo regimes, believes it is advisable to wait for the Collateral Directive to be adopted and implemented by the Member States before proposing a specific legislative instrument with regard to repo transactions.

The impact of the adopted Collateral Directive (and its eventual national implementations/declarations of opt-out by Member States) should be assessed prior to any discussion concerning any EU text that would harmonise repo transactions, in order to:

- evaluate its scope after its implementation in EU states' domestic laws, and assess whether the provisions of the Directive with respect to repo transactions, eligible securities, and parties to the transaction have been implemented restrictively, or in a broader manner that would include *corporates*;
- think about the adequate instrument for an harmonisation of the repo regime (Directive or Regulation) with regard to the remaining points.

Despite this recommendation to wait for the Member States to finalise implementing the Collateral Directive before working on a repo community law instrument, we feel that it is useful to touch on the items that will not be dealt with by the Draft Collateral Directive, such

as a definition of repo transactions as well as the accounting and tax treatment granted to repo operations. Considerations of the EFLMG on these issues therefore follows.

I. Survey of the European Directives referring to repo transactions

The definition of repurchase transaction has to be the first step towards increased harmonisation because of the necessity to :

- state the principle that the transfer of the full ownership is validly effected by the repo contracts;
- conversely, avoid any risk of re-characterisation. Indeed, as soon as a definition and parameters for repos (if needed) are defined (the parties authorised to enter into such transactions, the assets which can constitute the underlying), the risk of a challenge of the validity of the repo on the basis of a re-characterisation will be considerably reduced;
- protect the close-out-netting mechanism underlying many collateral arrangements. Indeed, for some Member States, there are restrictive conditions linked to the validity and the enforceability of repos or unnecessary formalities (e.g. administrative declaration...) apply which have to be complied with in order to benefit from the close-out-netting¹;
- erase differences between the Member States regulations, namely regarding the eligible underlying of repo transactions, the status of the parties authorised to enter into such transactions, etc....

A definition of repo transaction is also necessary for those European countries such as Denmark, UK, Sweden or Italy which have no definition in their regulations.

A survey of the existing European regulations referring to such transactions shall be effected in order to confirm the necessity to define the repos and to avoid any inconsistency with the existing European Texts.

Two European Directives and a previous version of the Draft Collateral Directive define repo transactions :

These definitions will be discussed in this section with a view to determine whether they adequately define repos for the purposes described above and how each should be amended if it were to be used for this purpose.

a) EC Directive 86/635 of December 8, 1986 on the annual accounts and consolidated accounts of banks and other financial institutions :

Article 12

1. Sale and repurchase transactions shall mean transactions which involve the transfer from a credit institution or customer (the "transferor") to another credit institution or customer (the "transferee") of assets, for example, bills, debts or transferable securities, subject to an agreement that the same assets will subsequently be transferred back to the transferor at a specified price.
2. If the transferee undertakes to return the assets on a date specified or to be specified by the transferor, the transaction in question shall be deemed to be a genuine sale and repurchase transaction.
3. If, however, the transferee is merely entitled to return the assets at the purchase price or for a different amount agreed in advance on a date specified or to be specified, the transaction in question shall be deemed to be a sale with an option to repurchase.

¹ Although the survey on the "cross-product netting" has been effected in the questionnaire, it was decided by the group not to include it in this statement. This important issue will be reviewed in a separate document.

4. In the case of the sale and repurchase transactions referred to in paragraph 2, the assets transferred shall continue to appear in the transferor's balance sheet; the purchase price received by the transferor shall be shown as an amount owed to the transferee. In addition the value of the assets transferred shall be disclosed in a note in the transferor's account. The transferee shall not be entitled to show the assets transferred in his balance sheet; the purchase price paid by the transferee shall be shown as an amount owed by the transferor.
5. In the case of the sale and repurchase transactions referred to in paragraph 3, however, the transferor shall not be entitled to show in his balance sheet the assets transferred those items shall be shown as assets in the transferee's balance sheet. The transferor shall enter under Off-balance sheet item 2 an amount equal to the price agreed in the event of repurchase.
6. No forward exchange transactions, options, transactions involving the issue of debt securities with a commitment to repurchase all or part of the issue before maturity or similar transactions shall be regarded as sale and repurchase transactions within the meaning of this Article.

➤ *Comments : is this definition adequate to ensure harmonisation ?*

- this definition adequately clarifies that both the "sale" and "repurchase" form part of a single repo;
- concept of "assets" is broad enough to include [most/all] financial instruments;
- "specified price" : to specify that subsequent transfer of the assets will be made at a price agreed on by the parties at the time when they enter into the repo;
- Although in this accounting directive, the distinction between "genuine" and "non-genuine" sale and repurchase transactions (which determine the accounting treatment to apply) is adequate, we do not feel that a repo definition to be used to ensure legal certainty need to cover non-genuine repos;
- the reference to "transaction" could be changed to "agreement" (term used in the following two definitions and which is broad enough to include the Master-Agreement as well);
- need to clarify that a valid and full transfer of ownership is operated through the repo agreement;
- a reference to the repurchase date could be inserted to state that fixed date repos and open repos are both covered;
- "same assets": we feel that this wording is adequate and allows for the retransfer of the assets or fungible equivalent of such assets;
- need to enlarge the scope of the parties (only credit institutions are covered in the existing definition).

➤ *Suggestion : is there a need for a definition of securities lending transactions or should there be a definition of "temporary title transfer including repos, securities lending, buy and sell back ?*

b) EC Directive 93/6 of March 15, 1993 « on the capital adequacy of investment firms and credit institutions » :

Article 17

Repurchase agreement and reverse repurchase agreement shall mean any agreement in which an institution or its counter-party transfers securities or guaranteed rights relating to title to securities where that guarantee is issued by a recognised exchange which holds the rights to the securities and the agreement does not allow an institution to transfer or pledge a particular security to more than one counter-party at one time, subject to a commitment to repurchase them (or substituted securities of the same description) at a specified price on a future date specified, or to be specified, by the transferor, being a repurchase agreement for the institution selling the securities and a reverse repurchase agreement for the institution buying them. A reverse repurchase agreement shall be considered an interprofessional transaction when the counter-party is subject to prudential coordination at Community level or is a Zone A credit institution as defined in Directive 89/647/EEC or is a recognised third-country investment firm or when the agreement is concluded with a recognised clearing house or exchange;

- *Comments : is this definition adequate to ensure harmonisation ?*
- Reference to "agreement" (see above);
- definition also expressly refers to "reverse repurchase agreements";
- a reference to the repurchase date could be inserted to state that fixed date repos and open repos are both covered;
- the concept of the securities is used to define the underlying assets ;
- need to widen scope of the parties covered by this definition : only financial institutions are covered at present;
- need to clarify that a valid and full transfer of ownership is operated through the repo agreement.
- *Suggestion : is there a need for a definition of securities lending transactions or should there be a definition of "temporary title transfer including repos, securities lending, buy and sell back ?*

c) The June 15, 2000 version of the Draft Collateral Directive on the cross border use of collateral also gave a definition of Repos (which has now disappeared from the February 26, 2002 common position) :

“sale and repurchase agreement” means an agreement under which a collateral provider sells financial instruments or interests in or in respect of financial instruments to a collateral taker subject to an agreement by the collateral provider to purchase and by the collateral taker to sell equivalent financial instruments at a future date (the “repurchase date”) or on demand, and at a price (the ”repurchase price”), specified in or determined as provided in the agreement and includes any term of such an agreement under which:

- (i) either party is obliged to transfer to the other full ownership of financial collateral² in order to maintain a specified ratio or margin between the current market value of the equivalent financial instrument due to be purchased at the repurchase date and the repurchase price; or
- (ii) the collateral provider is entitled, before the repurchase date, to require the collateral taker to transfer it full ownership of financial instruments equivalent to some or all of those sold in exchange for the transfer to the collateral taker of full ownership of other financial instruments by way of substitution;

➤ *Comments : is this definition adequate to ensure harmonisation ?*

- the reference to "agreement" (see above);
- the specific reference to "a future date or on demand" and to a pre-determined repurchase price;
- clearly states validity and enforceability of the full transfer of ownership.

➤ *Suggestion : is there a need for a definition of securities lending transactions or should there be a definition of "temporary title transfer including repos, securities lending, buy and sell back ?*

² "financial collateral" means cash in any currency and financial instruments.

II. The scope of the harmonisation

1. the necessity to unify the regime applicable to repos and the securities lending transactions.

The members of the EFLMG agree that it would be appropriate to include securities lending transactions in the scope of the text harmonising repo transactions. This is all the more advisable that securities lending transactions are not included in the scope of the Draft Collateral Directive.

2. Eligible counterparties (rationae personae)

The text harmonising the regime for repos should be applicable to all types of entities and not only financial institutions³ in order to assure a complete legal enforceability. The eligible entities should also include corporates. In the event where we limit the purpose of this text to exclude corporates, the success of the harmonisation could be reduced. This is also important because without a broad scope of the directive some entities may be put a competitive disadvantage. Therefore, the same treatment should apply without any distinction based on the status of the parties.

3. Securities eligible to repo transactions

The underlying assets should include [most/all] financial instruments. Indeed, according to the questionnaire, the Member States have already taken a broad approach as to eligible securities.

³ Alternatively, the text could include a requirement that at least one of the parties be a financial institution.

III. Tax and accounting treatment

From an accounting and tax viewpoint, repo transactions should be harmonised without distinction :

- As to the location where the counterparty is;
- As to its status (regime applicable in U.K makes this distinction);
- As to the type of securities underlying the repo (for example, regimes applicable in Finland and Austria make this distinction).

Also, a principle of accounting and tax neutrality shall apply and be built into any text harmonising the regime of the repos in Europe.

a) Tax Treatment

From a tax viewpoint, EFLMG members agree to consider that there should be no transfer of ownership of the securities and any financial instruments underlying the repos. The securities would remain with the seller for the whole duration of the transaction.

Such neutrality principle applies provided that the following conditions are met :

- both the sale and the undertaking to repurchase are firm commitments;
- the securities or any financial instruments need to be delivered to the buyer;
- one of the parties to the transaction is a financial intermediary.

However, members anticipate difficulties in harmonising the tax treatment as tax matters come within the remit of the Member States only.

b) Accounting treatment

In much the same manner, a principle of neutrality of the transaction must govern the accounting regime of repos transactions. European Directive 86/635/CEE as amended provides for this principle : in the event of a firm commitment to sell and to repurchase, the repoed securities remain on the seller's balance sheet for the whole duration of the repo transaction. There is no transfer of ownership in terms of accounting, even though there may be one legally.

IV. The adequate instrument to harmonise repo regime

The adequate instrument to operate this harmonisation is still to be defined. At the European level, two instruments are satisfactory : the Directive and the Regulation.

- The Regulation
- The Directive.

The choice of the medium is important because these instruments have different legal purposes.

The regulation has general application. It fixes a rule, imposes duties or grants rights to a category of people defined on objective basis. It is compulsory in all its elements and directly applicable in the Member States.

Unlike the Regulation, the Directive only applies to its designated recipients, i.e. all Member States or only some of them.

The Directive fixes goals to implement to but lets the Member States free to decide the means to reach the objective stated.

In practice, the directive is used more because of the flexibility for the Member States to choose the form of the national implementation measures. Also, the directive specifies the objectives i.e. which of the differences between the national regimes are to disappear. Its implementation means that each Member State applies and respects the objectives specified in the Directive.

The choice of the text harmonising the regime of the repos in Europe cannot be effected before the implementation of the Draft Collateral Directive. Indeed, in the event where the Member States include all the provisions concerning the repos and do not reduce the scope of these transactions (eligible parties, eligible assets, transfer of ownership and close-out netting), the resort to a directive is sufficient. However, if the references to repos in the national regimes are such that there is no unified regime, it would be better to opt for a European regulation which will be directly applicable.

Conclusion

The suggestion to harmonise the repos regime should be maintained. Indeed, as shown by the responses made to the questionnaire, the repo transactions effected in Europe are governed by different legal, tax and accounting regulations. Until a text harmonising such transactions is taken, European counterparties may have some difficulties in finalising their transactions in accordance with their respective regulations and be faced with legal uncertainties.

However, as explained above, it would be more appropriate to wait for the implementation of the Collateral Directive before suggesting a text which aims to cover the same issues in relation to repo transactions.

The text harmonising the regime of the repos in Europe should :

- propose a definition of these transactions taking into consideration the one set forth in the proposal of the Draft Collateral Directive dated of March 2001;
- include the accounting and tax treatment.

➤ **Proposal for a definition**

Starting from the definition stated in the previous version of the Draft Collateral Directive, the definition of the repo transactions could be as follows :

“sale and repurchase agreement” means an **agreement** under which a legal entity ("Seller") **transfers to another legal entity** for an agreed price ("the buyer") **full ownership of financial instruments or interests in respect of financial instruments** subject to an irrevocable agreement by Seller to purchase and by the Buyer to sell equivalent financial instruments at an agreed date (the “repurchase date”) and for an agreed price (the ”repurchase price”),² specified in or determined as provided in the agreement.

It is important that this definition includes the following criteria :

- Specify the two legs of this transaction : a sale and a repurchase. It should be stressed that although sale and repurchase occur at different times, they are completely linked ;
- Expressly state the transfer of ownership;
- Give a broad scope for the eligible assets and the parties which can enter into such agreement;
- Provide for the principle of tax and accounting neutrality.

Buy & sell back transactions should also be referred to in the definition and securities lending transactions should also be defined⁴.

We have a doubt as to whether reverse repos be referred to in the definition. This may seem inappropriate as they legally are the same as a repo but viewed from the other party's perspective.

⁴ Securities lending and repos could both be defined as temporary title transfer transactions for instance.