ICMA ERCC consultation on the role of repo in green and sustainable finance: summary report

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Introduction

On 22 April, the ICMA European Repo and Collateral Council (ERCC) published a consultation paper on the role of repo in green and sustainable finance, exploring the sustainability aspects of repo and collateral as well as assessing the existing opportunities and potential risks in this area. In particular, the paper looked at three possible intersections between the repo and collateral market and sustainable finance: 1. Repo with green and sustainable collateral; 2. Repo with green and sustainable cash proceeds and 3. Repo between green and sustainable counterparties.

The paper was published alongside a list of consultation questions and was intended to serve as a starting point for promoting a broader discussion in the repo community on sustainability. The market consultation took place between 22 April 2021 and 4 June 2021. In total, 20 responses were received, representing views from 18 firms[1].

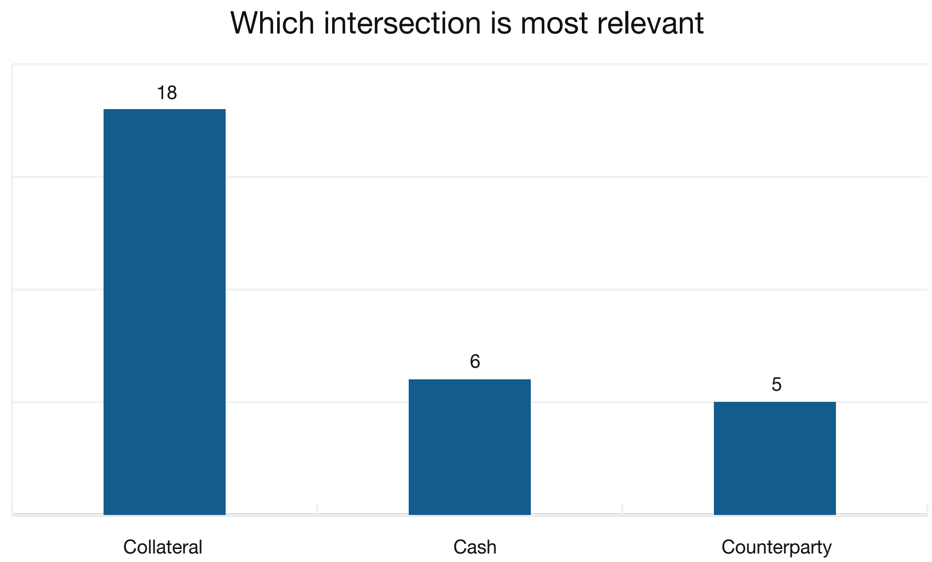
The objective of this summary report is to assess the feedback received to the consultation paper, highlighting the key themes raised by the respondents for each of the questions. The comments summarised in this report do not illustrate ICMA views, rather they are intended to outline the responses from the market. Where helpful we included quotes from individual responses to complement and elaborate on specific points. The consultation feedback has been presented and discussed at the relevant ICMA Committees such as the ERCC Committee and the Sustainable Finance Committee. As noted in the conclusion, the proposed next steps will be taken on a basis that is consistent with the global standards of the Green & Social Bond Principles promoted by ICMA.

This summary report only considers responses received during the consultation period and therefore reflects the views of a limited number of respondents. However, the discussion on the topic is ongoing and further feedback is welcome. If you have any additional comments or questions, please contact ercc@icmagroup.org

1 See end of the report for the full list of firms that responded to the consultation.

Q1. Which of the intersections between repo and sustainability described in Section 3 are most relevant to your firm? Please detail the reasons for your response.

20 responses received in total[2].



Majority of the responses agreed that "**green collateral repo**" is relevant to them and that it is the most straightforward concept to implement.

- Beyond supporting market liquidity, respondents also noted other important functions of this type of repo for green and sustainable bond markets, such as facilitating market making (by acting as intermediaries), supporting primary market issuance and fostering price discovery.
    - o *"…operating in the capacity as a market intermediary, rather than investor in reverse repo... Incentivizing market makers to facilitate green repo transactions will further help achieve green and sustainable finance objectives as well as support the transition of clients."*
    - o *"…Treasury may provide short-dated financing of positions to primary dealers as bonds work through the new issue and syndication process. This also creates liquidity in the market and supports primary issuance."*
- On the other hand, one respondent cautioned that "green collateral repo" might not provide the necessary transitional environmental benefits if it is strictly limited to green collateral. They pointed out that in the green loan market, for example, the CBI certification for Green ABS, non-green assets are often accepted as securities for secured finance which will then be used to produce green assets. Such an open approach would enable and facilitate better transition compared to "green collateral repo" where only green assets are used as collateral.

6 respondents indicated that "**repo with green and sustainable proceeds**" is relevant to them.

- *"[It] would complement [our] existing suite of green financing products such as green term deposits, climate bonds and commercial paper, which are allocated towards the financing of the banks green assets, which are in effect green loans which finance our clients' green "Hard" assets like green buildings, renewable energy, electric transport etc. The creation of green liability products allows us to support investor clients with appropriate climate related product offerings."*

2 Please note that the consultation questions published alongside the paper were all open questions. Respondents could choose to comment on a particular aspect or all aspects of a question, therefore figures are indicative and may not add up to the total.

- However, respondents also raised different concerns regarding this approach, noting that it may be:
  - technically complicated i.e., difficult to verify given the fungibility of cash
  - not fit for purpose for short term financing
  - likely to incur extra costs
  - restricted in terms of the use of proceeds which makes it less attractive to cash takers
  - Unable to materialise trading-related benefits as the proceeds are for fixed use only. This means it is unable to encompass short-selling and matched-book trading and cannot be extended to cash trading, securities lending against non-cash collateral or derivatives.
- Several respondents suggested that a form of "use of proceeds repo" could be considered in the long run as the market evolves.

5 respondents highlighted that looking at **counterparties**' ratings and ESG characteristics when trading is important to them.

- Several respondents believed that although this approach may not be applicable under current the operating environment, it is something to be considered as counterparty classification evolves.
- One respondent noted that the "*use of the counterparty as a basis for measuring green financing is already being applied in the case of green money market funds. It also allows the inclusion of short-selling as well as securities lending against non-cash collateral and other trading activities.*"

As a more general comment, some respondents noted that the different intersections described in the paper and the related **product features are not mutually exclusive.**

Q2. Are there any other possible intersections between the repo market and sustainable finance which your firm is considering but are not covered in the paper? Please explain.

4 respondents mentioned the idea of "**sustainability-linked repo**" in which counterparties have to fulfil certain ESG KPIs (Key Performance Indicators) or SPTs (Sustainability Performance Targets) to get cheaper cash (i.e., pay lower interest). This is a type of repo in which the economics of the trade can vary depending on the counterparty achieving predefined sustainability objectives.

Other intersections suggested by respondents include the following:

- Consider the use of **other green, social, sustainability, and sustainability-linked (GSSS) debt instruments** beyond just bonds as collateral such as loans, trade finance, letters of credit.
- **Green collateral swaps:** one party receives high rated liquid non GSSS collateral and transfers in return GSSS collateral to their counterparty for a fee.
- **Mixed collateral pools:** 1. a mix of different underlying GSSS collateral; 2. A mix of GSSS with a small percentage of non-GSSS collateral, while ensuring certain brown sectors are excluded.
- Consider GSSS issued by green and sustainable entities, in other words, the issuer's green profile matters without the actual debt instrument being Green, Social or Sustainable.
- Consider green collateral used in the context of margining process.
- Consider quoting repo transaction in terms of a sustainable collateral reference index or rate (which would be derived from green and sustainable collateral transactions):
    - *"A sustainable repo transaction could also be **based upon an index of sustainable collateral** for cash management purposes (i.e. the cash leg of a repo transaction could be aligned to an index based on green, social, sustainable and sustainability-linked bonds classified under the ICMA's respective guidelines and principles)."*

Q3. Do you agree with the opportunities listed in Section 4? Do you foresee any other opportunities in developing a green and sustainable repo market? Please detail the reasons for your response.

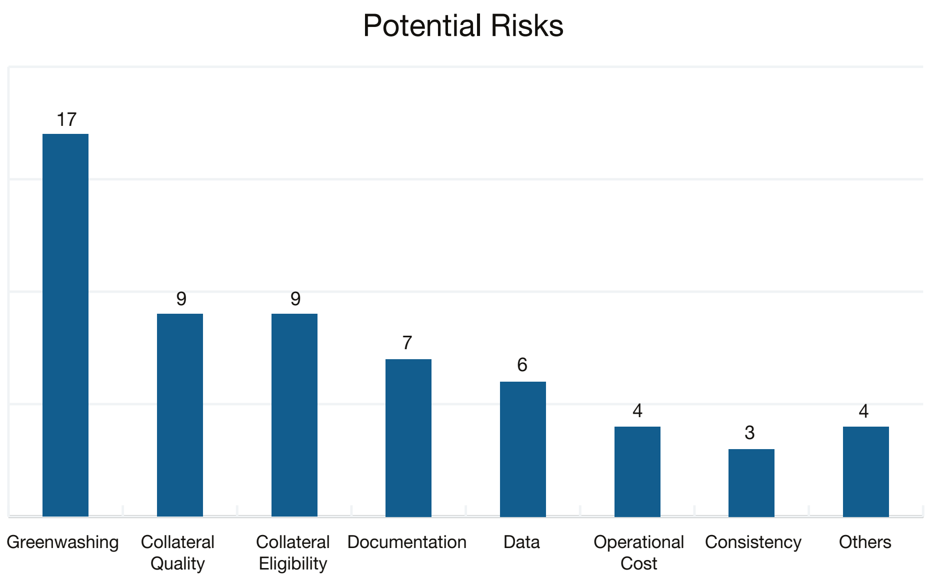
17 respondents viewed "supporting liquidity and collateral fluidity" as the top opportunity. **11** respondents agreed with all the opportunities listed in section 4[3].

Other opportunities raised by respondents include the following:

- As mentioned in Q1, several respondents see other benefits in "green collateral repo" beyond market liquidity such as **facilitating market making, supporting primary market issuance** and **fostering price discovery** for green and sustainable bonds.
- Some respondents suggested that there is still room to further develop and expand **triparty ESG collateral baskets**, e.g. by including different ESG criteria.
- A few respondents saw opportunities in other areas such as:
  - Structured financing on ESG collateral to ensure the proceeds will be invested in ESG oriented investments.
  - Facilitate wider ESG governance policies through the facilitation of active management of non-green collateral as well as creating a negative demand for "brown" collateral through exclusions in collateral sets.
  - Material growth in the sector may manifest into new incentives by Central Banks on liquidity metrics or funding channels.

3 Opportunities listed in Section 4 in the paper were: Supporting liquidity for green assets; Creating additional funding for green projects; Benefits for users of green and sustainable repos which includes reputation and client demand, transition of business models, first mover advantage.

Q4. Do you agree with the risks listed in Section 5? Which of them do you consider the most relevant to your firm? Do you foresee any other issues relating to the development of a green and sustainable repo market? Please detail the reasons for your response.



17 respondents agreed with "**greenwashing**" as the top concern. More specifically, respondents mentioned the following risks:

- Incorrect classification of products as "green" investment.
- Double counting: for "green collateral repo" where no additional green assets are created or no additional funding goes into green activities, if both the buyer and the seller of the repo claim the green collateral as their own green investment, this would lead to double-counting.
  - o *"In the case of repo used as an end-investment, collateral is not an appropriate basis as it would lead to double-counting between the investment in the collateral by the seller, who retains the risk and return, and the investment of cash by the buyer"*
- Lack of additionality: the simple transfers of green bonds in a repo transaction do not really inject any additional capital into the green finance ecosystem.
- Reputational risks for firms relating to "greenwashing".

However, some respondents believed that "greenwashing" could be mitigated with appropriate industry guidelines and definitions or regulatory directives. Proposed approaches to avoid "greenwashing" included the following:

- Consistent approach for measuring green investments: Ensure that green investments are only counted once, i.e., they should only be considered for the sustainability metrics of one of the parties to the transaction. However, there were different views on whether it is the buyer or the seller in a repo who should count the green collateral towards its own green investment.
  - o Most respondents who commented on this point believed that it should be the repo seller as they are financing the green assets and retain the economic exposure to the assets:
    - ■ *"We also think that only the buyer of the bond (investment portfolio) should count the bond as its own green investment even if it repos it."*

- One respondent also believed it should be the repo seller but stressed that this should only be the case if the cash is an end-investment, i.e., no further trading of the green collateral:
    - *"In view of the economics of repo, it is logical, and would be in line with accounting treatment, as well as the temporary and short-term character of most repos, to continue to regard the seller as having made the green investment represented by the bond being used as collateral. However…the situation is more complicated where the buyer has funded through a matching repo, that is, where a green bond is traded across a matched repo book. In this situation, an intermediary is contributing to the liquidity of the market in that green and this should be recognized."*
- On the other hand, one respondent argued that the buyer of the repo should receive some credit and proposed an "allocation contribution" approach such as annualising the value for repo to account for the short-term nature of the product:
    - This would be pro-rated based on the term of the repo.
    - The investment fund that repo'd the bond receives zero value for the transaction for the term of the repo. However, the investment fund can receive value if they invest the funds into an ESG bond or other qualifying investment.

- Consider a category of "green collateral repo" with stricter criteria where:
    - *"The client commits to use the funds to finance or refinance a direct investment in ESG bonds [and] to maintain the ESG investment throughout the life of the repo trade; the provider of the financing will use its own resources to finance the transaction and commit not to [reuse] the collateral. This is important to assure uniqueness of the liquidity provider of this transaction."*
- One respondent proposed some metrics for measuring the attribution of repo to green financing. The respondent pointed out that the attribution should be calculated differently for repos where the cash is an end-investment (funded by equity, capital, reserves or the re-investment of managed funds) and traded repos (where an intermediary is contributing to the liquidity of the market in that green bond). The proposal is summarised in the table below:

	collateral	cash	counterparty
end-investment	seller remains green investor for market value of collateral	buyer can be green investor depending on use-of-funds and term of repo	market value of green bonds times counterparty green weight (a percentage weight derived from an assessment of the alignment of the counterparty with sustainable objectives)
trading	the amount of capital allocated to bond trading times share of green bonds in trading	n/a	n/a

On the other hand, a few respondents did not believe "greenwashing" was a significant issue in the context of repo and provided the following reasons:

- *"We do not think that repo with green collateral is not consistent with the existing market standards as the initial cash proceeds have been allocated to real eligible green projects at the moment the investor bought the bond."*
- *"We have been less concerned about the short-term nature of the funding under a repo transaction as it relates to Greenwashing as ultimately the goal of the repo is to provide market counterparties with liquidity, reduce the cost of financing and provide access to funding to counterparties who may not otherwise have access on an unsecured basis. As such we view this as improving the overall market and supporting sustainable finance activities."*

9 respondents considered collateral eligibility in relation to "brown" assets as well as central bank eligibility as a potential risk:

- *"We believe the integrity of the collateral pool as it relates to ESG characteristics should be maintained throughout the life of the Repo and in situation where there is a collateral replacement or substitution event. We do not believe market based repos should be linked to ECB or other regulatory forum eligibility but rather what constitutes and what is accepted by the market as Green, Social, Sustainable and Sustainability-Linked collateral".*

9 respondents considered collateral quality as a potential risk as green does not necessarily mean better credit:

- *"ESG-aligned collateral could legitimately be considered superior to traditional collateral only (1) if it provided protection against ESG risks likely to be realized during the life of the collateral and (2) if this ESG protection was entirely additional to the credit and liquidity protection normally required of collateral. In the case of government securities, unless the country of the issuer is particularly exposed to ESG risks, there is little or nothing to be gained from using ESG-aligned issues as collateral unless investors were to exhibit a sustained systematic preference for ESG-aligned issues even in periods of market stress."*

9 respondents commented on the potential implication for legal documentation but overall suggested that there should be minimal or no change to the GMRA and that any necessary adaption should rather be reflected in an ad-hoc side agreement outside the GMRA itself.

- *"Great care needs to be taken not to make changes to the GMRA which could undermine the legal robustness of repo and the competitiveness of the agreement. It is not clear why a "Green Annex" would be needed…"*
- *"Don't expect a big impact under GMRA documentation. Certain structured transactions might need ad-hoc documentation in case the proposed transaction is more restricted."*
- *"We agree that documentation should be standardised (i.e. to include use of proceeds for Green and General Corporate Purposes for linked), however, think that this is best done externally of the GMRA and by way of a side agreement."*

Some respondents also noted the need for additional monitoring, reporting and framework agreements especially for products based on the of use of proceeds:

- *"Minimising the need for documentary change will aid adoption…The practicality and burden of any additional reporting must be considered."*
- *"In respect of Use of Proceeds application of GSS repos where the Use of Proceeds are not utilised by the counterparty according to an existing GSS bond framework which references ICMA existing best-in-class principles, the repo documentation will need to provide for a framework around application of use-of-proceeds, monitoring and reporting."*

6 respondents still thought data is an issue and pointed out some related data coverage gaps although some respondents also believed this can be addressed by reference to industry best practices and firms' own taxonomies. More specific issues raised in this context:

- *"Electronic trading platforms and information vendors have started attaching green tags to some bonds, but the ability to easily identify a green or sustainable bond is not always clear on platforms or within dealer inventories."*
- *"How to handle the difference between securities that are non- 'green bond' vs those that have not yet been reviewed/ rated?"*

4 respondents mentioned the extra **operational costs**, especially in relation to the use of proceeds:

- "*We do see possible additional Operational cost implications due to Use of Proceeds application to ensure reporting and monitoring obligations are complied with"*
- *"It is likely that these costs will largely arise from gathering, validating and applying data in large part to meet disclosure requirements."*

3 respondents were concerned about the difficulties in aligning standards and definitions and stressed the importance for **global consistency** and coordination:

- *"Make up quality of green assets /triparty sets would still need client to opine on. Some clients may be different so potentially difficult to have one standardised set across the market."*

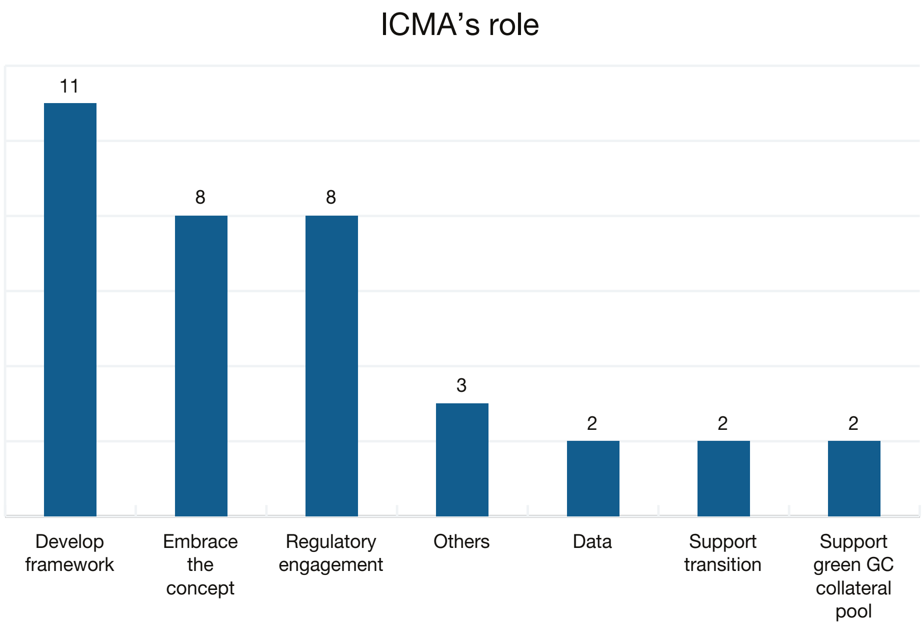
Other areas of concern raised by respondents include the future development of the related regulations and how to create the right incentives for market participants, whether there is enough supply of green collateral as well as trading with counterparties who fall below the firm's internal ESG ratings:

- **Regulation:** *"1. Clear regulation could drive to a preference for ESG assets and a rejection for brown assets - drive to a widening in the spread between both assets, punishing the brown and even becoming illiquid; 2. No clear regulation on ESG assets could drive to a disappointment in market participants to finance green/sustainable assets, therefore lack of liquidity in the secondary market and disincentive for investors to finance their ESG portfolios"*
- **Collateral availability:** *"Enough issuance of green bonds to create enough liquidity in the secondary market? enough investors who are willing to participate in the repo market?"*
- **Counterparty eligibility** i.e., the risk of *"not to transact a Green Repo or Green Collateral Repo with a counterparty below internal ESG rating/criteria eligibility definition."*

One respondent also noted repo should be structurally and functionally agnostic to the type of collateral, the purpose of funding or the type of counterparty. Although the operational management and risk/return maybe affected, the legal structural and fundamental economic operation of a repo will not change:

- *"Repo does not need to be re-invented in order to facilitate ESG financing and there is a risk of unintended consequences in attempting to do so. Repo and the repo market do have an essential role to play in catalyzing ESG bond markets and enabling efficient liquidity management by ESG-aligned firms, but it will do so in its current form."*

Q5. In your opinion, what could and should ICMA do to contribute to the development of a green and sustainable repo market? Please detail the reasons for your response.



11 respondents suggested that ICMA should provide **clear definitions and standard approaches** for different types of "green repo". Among other things, respondents commented that ICMA should produce guidelines or a specific framework similar to the ICMA's Green & Social Bond Principles.

8 respondents thought that a key role for the ERCC should be to **actively embrace the concept** of sustainability, and to be more visible in the market, to encourage debate and facilitate discussion. It was suggested that ICMA should collaborate closely with other trade associations and market bodies. Respondents also felt that it would be beneficial to assess the adverse impacts and risks on 'non-green' finance.

8 respondents believed that ICMA should continue with its active **regulatory engagement.** This may include:

- Monitoring and educating on existing regulations and requirements.
- Supporting the development of potential or upcoming regulations and requirements.
- Ensuring that the role repo plays in capital markets is understood and recognised by regulators.

Other suggestions included:

- Engaging with the relevant tri-party agent to support the development of green GC collateral pools
- Helping with rating systems, data quality and data availability, possibly including reporting of verified data (i.e., volumes and values) for green repo through ICMA's European Repo Survey.
- Supporting a smooth transition, considering a:
    - phased approach with achievable, scalable and standardised parameters, as well as
    - different shades of transitional efforts in the different regions and economies.

Q6. In your opinion, do you think the developing regulatory framework supports the role of repo and collateral in the broader context of sustainable finance? Do you think monetary policy can be further adapted to support the role of repo and collateral in sustainable finance?

8 respondents believed that some sort of "**incentive**" would help to further encourage the sustainable repo market. This could involve:

- Preferential treatment, e.g., haircut advantages, capital relief, liquidity benefits, less constrained concentration limits
- Differentiated rates for funding facilities
- Consider ESG assets HQLA

On the other hand, one respondent warned about the risks of ESG-related incentives, commenting:

- *"Purely ESG-targeted incentives could distort the value of collateral. This would become apparent in a market crisis, when creditors will focus exclusively on financial risks, and could undermine confidence in collateral at the worst moment, with potentially systemic consequences."*

4 respondents commented that a **clear regulatory framework** for SFTs which brings standardisation or harmonisation globally would be welcomed but also stressed the need for sufficient flexibility to avoid unnecessary constraints.

4 respondents suggested that risk-based regulations could support the growth of the market through **increased allocation/holding of green assets** e.g., through a minimum GAR (Green Asset Ratio).

Some respondents also agreed that **monetary policy** could have an important role to play:

- *"Monetary Policy being executed using ESG instruments brings extra focus and liquidity which can only increase the need for repo instruments of the same nature."*
- *"Central bank monetary policies can be further adapted through the adoption of greener eligibility criteria to further promote funding of the green Repo market."*
- *"They could support the green bond market through the purchase of bonds whose issuers follow strict climate-related reporting requirements or even consider bonds' rating that take an acceptable account of climate-related financial risk into consideration".*

However, one respondent warned about the significant risks related to such an approach:

- *"Biasing the framework to encourage ESG financing will redirect monetary policy to some degree away from its macroeconomic objectives and towards microeconomic management of capital flows for politically-preferred uses…. This would ultimately threaten the independence of the central bank… Policy should instead aim at ensuring that ESG risks are adequately factored into asset prices in order that the market can efficiently incorporate ESG-driven financial risks by encouraging the production, quality and transparency of ESG data."*

Overall, some respondents noted that a number of authorities have already signalled the importance of sustainability as a main driver of their policy, but some respondents also thought that regulation still has a long way to go:

- *"The regulatory framework around this is very much still in the process of bedding down, and I think it remains largely conceptual up to this point (in the sense that the most detailed rules have yet to be clarified/ come into force…"*
- *"..it seems too many fragmented regulations already in place or planned. That already leads to a non-harmonised definition of green bonds.."*

Lastly, a few respondents expressed concerns about disproportionate **regulatory cost:**

- *"We are not in favour of new regulatory ratios (such as Green Asset Ratio) or any additional regulation as banks face ever increasing regulatory costs. But as it proved in the past, this is the only way to move things forward and to reach this common goal in the industry on the 'near term'…"*

Next steps

Over the past year, ICMA's ERCC has been actively engaging in the development of the sustainable repo and collateral market as part of ICMA's central role in supporting the sustainable debt capital markets and in developing global standards. The consultation has been a first useful outcome of this effort and as part of the feedback, many respondents appreciated the ERCC's initiatives on this topic and hoped to see further follow-ups and development. In the context of this paper, the ERCC Committee already had a number of engaged discussions on the role of repo in facilitating ESG financing. In addition, the ERCC's Best Practice Working Group will consider potential best practice implications which would be reflected in the ERCC Guide to Best Practice in the European Repo Market to help repo market users prepare for the growing importance of ESG and the related requirements.

Upon reviewing the market feedback received in response to this consultation paper, and given the suggestions provided by respondents, especially on Question 5 (what could and should ICMA do to contribute to the development of a green and sustainable repo market?), ICMA is in the process of establishing a dedicated taskforce under the auspices of the Executive Committee of the Green & Social Bond Principles, to work with the ERCC with the aim of developing potential guidance on repo and sustainability. This will be done on the basis of a consistent approach with the global standards of the Green & Social Bond Principles promoted by ICMA.

List of respondents

Arbejdsmarkedets Tillægspension, ATP

Banco Bilbao Vizcaya Argentaria

Banco Santander SA

Belfius Bank

BlackRock

BNP Paribas

Bank of America

Clearstream Banking

Commerzbank AG

Commonwealth Bank of Australia

Daiwa Capital Markets Europe Limited

Deutsche Bank

Eurex

Insight Investment

LSEG

M&G

Richard Comotto (independent consultant)

Standard Chartered Bank

UBS

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