

MEMO# 28491

October 28, 2014

FSB Issues Policy Recommendations on Securities Lending and Repo "Haircuts"; Requests Further Comment on Extension of Numerical Haircut Floors

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 29-14
ICI GLOBAL SECURITIES LENDING & REPO TASK FORCE No. 1-14
INTERNATIONAL MEMBERS No. 37-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 31-14
SEC RULES MEMBERS No. 42-14 RE: FSB ISSUES POLICY RECOMMENDATIONS ON
SECURITIES LENDING AND REPO "HAIRCUTS"; REQUESTS FURTHER COMMENT ON
EXTENSION OF NUMERICAL HAIRCUT FLOORS

As you know, the Financial Stability Board has issued a number of consultations over the past two years addressing perceived financial stability risks in the securities lending and repo markets. The FSB continues to finalize parts of that work, most recently with its publication of a recommended policy framework for "haircuts" on collateral in non-centrally cleared securities financing transactions. [\[1\]](#) The final recommendations include minimum standards for methodologies to calculate haircuts and a framework of numerical haircut floors, both summarized briefly below.

Background

The FSB's workstream on securities lending and repos (WS5) has produced a series of reports and consultations focused on the need for enhanced transparency, additional regulation, and improvements to market structure in the securities lending and repo markets. [\[2\]](#) The FSB made final policy recommendations in many facets of this work in August 2013. [\[3\]](#)

At that same time, it published further consultations on one of the more controversial aspects of its work—proposals for minimum qualitative standards for methodologies to calculate haircuts and a framework of numerical haircut floors. On October 14, the FSB made final policy recommendations in those two remaining areas.

The October 14 report also contains one further consultation. The FSB is seeking comment

on whether to extend its framework of numerical haircut floors to non-bank-to-non-bank securities financing transactions.

ICI and ICI Global have submitted numerous comment letters on the FSB's work in this area. [\[4\]](#) We opposed the FSB's latest proposals on margin haircuts, based primarily on our belief that the FSB's focus on haircuts was misplaced and its recommendations inappropriately dictated terms best left to the parties to negotiate. [\[5\]](#)

Minimum Qualitative Standards for Methodologies

The first element of the FSB's regulatory framework on haircuts involves qualitative standards for methodologies used by market participants to calculate haircuts on the collateral received in securities financing transaction. The FSB intends these minimum standards to be incorporated into existing or new regulatory standards.

Unlike the numerical schedule of haircut floors discussed below, the scope of these recommendations on methodologies is broad; they appear to relate to all securities financing transactions, including securities lending and repo.

The FSB recommends that haircuts should be based on the market risks of the assets used as collateral and be calibrated at a high confidence level, using a long historical time period that includes at least one stress period, in order to cover potential declines in collateral values during liquidation. This part of the FSB's report contains a number of detailed recommendations toward these ends:

- Haircut methodologies should be designed to limit potential procyclical fluctuations in haircuts, specifically by moderating the extent to which they decline in benign market environments and thus mitigate the magnitude of the potential increase in volatile markets;
- Haircuts should be set to cover, at a high level of confidence, the maximum expected decline in the market price of the collateral asset, over a conservative liquidation horizon before a transaction can be closed out;
- Haircuts may be calculated either on a transaction level basis or at the collateral portfolio level depending on individual circumstances;
- Haircut methodologies should not be based on a rolling short window, e.g. two years or less, of recent price data, but rather based on a long time series of price data that covers at least one stress period; [\[6\]](#)
- Where feasible, historical bid-ask spreads and pricing uncertainty should also be examined to consider the possibility that stressed market conditions may lead to a widening of bid-ask spreads and a reduction in the market liquidity of a given type of collateral; and
- The assumed liquidation horizon should be conservative, reflect the expected liquidity or illiquidity of the asset in stressed market conditions, and depend on the relevant market characteristics of the collateral, such as trading volumes and market depth.

Where relevant, the FSB also recommends that haircut methodologies also take into account other relevant risk considerations, such as:

- The risk of liquidating large concentrated positions (liquidation risk), and the “wrong-way risk” between collateral value and counterparty default;
- Specific characteristics of the collateral, which include asset type, issuer creditworthiness, residual maturity, price sensitivity (such as modified duration), optionality, complexity of structure, expected liquidity in stressed periods and the

- frequency of collateral valuation and margining;
- The creditworthiness of, and existing exposures to, counterparties;
- The foreign exchange risk in cases where there is a currency mismatch between the currency of denomination of the collateral and the counterparty exposure (e.g. cross-currency repos); and
- The correlation between securities accepted as collateral and securities loaned in securities lending transactions.

The report includes additional recommendations for calculating haircuts on a portfolio basis, which include both specific methodologies and general methodologies, such as the need for robust stress testing and appropriate internal processes and procedures.

Ultimately, the FSB recommends that “regulatory authorities should set qualitative standards for the methodologies that firms use to calculate collateral margins/haircuts, whether on an individual transaction or portfolio basis, and should review those standards against the guidance set out above by the end of 2017.” As an interim step, the FSB recommends that “standard setters (e.g., the Basel Committee on Banking Supervision) should review existing regulatory requirements for the calculation of collateral haircuts in line with this recommendation by the end of 2015.”

Numerical Floors on Haircuts

The second element of the FSB’s framework is a numerical schedule of haircut floors that would apply to a much narrower universe of securities financing transactions. These recommendations relate solely to non-centrally-cleared securities financing transactions in which financing against collateral other than government securities is provided to non-banks. The FSB notes that the framework of numerical haircut floors is intended to apply to transactions where the primary motive is to provide financing, rather than to borrow or lend specific securities. It therefore specifically exempts cash-collateralized securities lending transactions.

In our November 2013 comment letter on the proposal, we strongly supported this narrow scope, which excludes transactions backed by government securities and transactions where the non-bank is providing financing, such as where a money market fund is a repo cash lender. Narrowing the scope in these ways alleviated many of our concerns with earlier proposals.

With respect to the narrow universe of transactions to which it applies, the FSB recommends the following haircut floors:

Residual maturity of collateral

Haircut level

Corporate and other issuers

Securitized products

≤ 1 year debt securities, and Floating Rate Notes (FRNs)

0.5%

1%

> 1 year, ≤ 5 years debt securities

1.5%

4%

> 5 years, ≤ 10 years debt securities

3%

6%

> 10 years debt securities

4%

7%

Main index equities

6%

Other assets within the scope of the framework

10%

The FSB explains that these numerical haircut floors are not intended to dictate market haircuts, and market participants should conduct their own assessment as to the appropriate level of haircuts to apply in individual circumstances, considering all relevant risk factors. Market participants are encouraged to determine their own, more granular risk-based haircut schedules, in accordance with the methodology standards as set out above, and to set higher haircuts than any regulatory numerical haircut floors where prudent.

For bank-to-non-bank transactions, the FSB recommends that the BCBS incorporate the numerical haircut floors into the capital requirements for securities financing transactions within the Basel III framework by the end of 2015. Following that, other authorities should implement numerical haircut floors for bank-to-nonbank transactions either by implementing the relevant changes in the Basel III framework or by requiring banks in bank-to-non-bank transactions to conduct transactions above the numerical haircut floor or collect minimum excess margin amounts consistent with the numerical haircut floors.

Further Consultation

Annex 4 of the report contains one further consultation. The FSB is seeking comment on whether to extend its framework of numerical haircut floors to non-bank-to-non-bank securities financing transactions. This would cover, for example, non-traditional repo where neither counterparty is a bank or broker-dealer.

Although it recognizes that the current value of outstanding non-bank-to-non-bank transactions to be small, the FSB states that “that could change in the future as market practices and activities evolve,” and that it “believes that expanding the applicability of the numerical haircut floors would help ensure that shadow banking activities are fully covered, reduce risk of regulatory arbitrage, and maintain a level-playing field between bank and non-bank lenders. Furthermore, it would avoid encouraging a shift of securities financing transactions to non-bank-to-non-bank transactions that is driven by a desire to circumvent regulatory requirements.”

Comments are due on this consultation on December 15. ICI and ICI Global are considering whether to comment.

Robert C. Grohowski
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endnotes

[1] Strengthening Oversight and Regulation of Shadow Banking, Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions (October 14, 2014), available at http://www.financialstabilityboard.org/publications/r_141013a.pdf.

[2] Annex 1 of the report contains a helpful status report for all of WS5’s deliverables.

[3] See ICI [Memorandum](#) No. 27560 (September 12, 2013).

[4] See Letter to the Secretariat of the Financial Stability Board from Karrie McMillan (November 27, 2013), available at http://www.financialstabilityboard.org/publications/c_131220n.pdf. An appendix to that letter contains links to prior ICI and ICI Global comment letters on this topic.

[5] See ICI [Memorandum](#) No. 27734 (November 29, 2013).

[6] The FSB notes that this recommendation goes beyond the current Basel III requirements for banks permitted to calculate regulatory haircuts using “repo VAR” models or “own estimates”, which require the use of at least two years of data.