

MEMO# 27560

September 12, 2013

FSB Issues Policy Recommendations on Securities Lending and Repo Markets; Requests Further Comment on Minimum Haircuts

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 78-13
ICI GLOBAL SECURITIES LENDING & REPO TASK FORCE No. 4-13
INTERNATIONAL MEMBERS No. 43-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 21-13
SEC RULES MEMBERS No. 86-13 RE: FSB ISSUES POLICY RECOMMENDATIONS ON
SECURITIES LENDING AND REPO MARKETS; REQUESTS FURTHER COMMENT ON MINIMUM
HAIRCUTS

Last November, the Financial Stability Board [\[1\]](#) published for comment policy recommendations for addressing financial stability risks in the securities lending and repo markets (the “2012 Consultation”). [\[2\]](#) The FSB now has issued final policy recommendations on most of the areas discussed in the 2012 Consultation, including enhanced transparency, regulation of securities financing, and improvements to market structure (the “Report”). [\[3\]](#)

The Report is summarized below. Two points are worth highlighting, however, as they bear directly upon areas of significant comment from ICI and ICI Global. First, the FSB changed its proposed recommendation that repo collateral should be of a type that is able to be held outright without breaching laws or regulations following a counterparty failure. We had strongly disagreed with that proposed principle insofar as it could have been interpreted to require money market funds, for example, to limit repo collateral to those instruments that are eligible securities under Rule 2a-7. The FSB replaced the word “outright” with “for a period of time,” making the final recommendation more consistent with provisions in Rule 2a-7. Second, the FSB did not adopt recommendations on mandatory minimum numerical “haircuts”—one of the most controversial aspects of the 2012 Consultation. Instead, the FSB has included a second consultation with proposals on minimum standards for methodologies to calculate haircuts and a framework of numerical haircut floors. The proposed haircuts are far lower than those in the 2012 Consultation. This further

consultation is summarized at the end of this memorandum. Comments will be due to the FSB on November 28.

Financial Stability Risks in Securities Lending and Repo Markets

The Report begins by describing the financial stability risks the FSB perceives with respect to the securities lending and repo markets. The FSB explains that “the use of securities lending and repos can lead to ‘bank-like’ activities, such as creating ‘money-like’ liabilities, carrying out maturity/liquidity transformation, and obtaining leverage, including short-term financing of longer-term assets, some of which may run the risk of becoming illiquid or losing value.” The Report highlights seven perceived financial stability risks and assigns policy goals to each:

Financial Stability Risk

Corresponding Policy Goal

Using repo to create short-term, money-like liabilities, facilitating credit growth and maturity/liquidity transformation outside the banking system can pose a risk to financial stability by aiding the build-up of excessive leverage and maturity transformation outside the reach of prudential liquidity and capital regulation.

To ensure sufficient transparency to the authorities and limit risks to financial stability from excessive leverage and maturity transformation.

Securities lending cash collateral reinvestment can involve maturity and liquidity transformation, which if left unchecked can present risks and negative externalities to firms beyond the beneficial owner or agent lender in a stress event.

To subject cash collateral reinvestment to regulatory limits on liquidity and leverage risks.

A banking system based on securities financing may be more procyclical because of the direct relationship of funding levels to fluctuating asset values and (via the levels of haircuts) volatility.

To restrict, or put a floor on the cost of, securities borrowing against assets subject to procyclical variation in valuations/volatility, to reduce the potential for the excessive leverage to build-up and for large swings in system leverage when the financial system is under stress.

Following a counterparty default, some creditors in the repo financing and securities lending segments are likely to sell collateral securities immediately (a “fire sale”), because of regulatory restrictions on portfolio holdings, limited operational or risk management capacity, or a need for liquidity. This may lead to sharp price falls that create mark-to-market losses for all holders of those securities. These losses can in turn lead to fresh rounds of fire sales by other firms, thereby creating an asset valuation spiral.

To mitigate the risk that large forced sales of collateral in one market segment arise as a channel of risk transmission beyond that market segment and throughout the broader financial system.

Re-hypothecation of client assets can create financial stability risks especially if clients are uncertain about the extent to which their assets have been re-hypothecated, or about the treatment in case of bankruptcy. For example, uncertainty may increase the possibility of a

run on a prime-broker if there are concerns about its credit worthiness.

To reduce financial stability risks arising from client uncertainty about the extent to which assets have been re-hypothecated and the treatment in case of bankruptcy, and to limit re-hypothecation of client assets (without an offsetting indebtedness) to financial intermediaries subject to adequate regulation of liquidity risk.

Interconnectedness arising from chains of transactions involving the re-use of collateral with large exposures among financial institutions creates a risk of contagion.

To reduce (i) the risk of financial contagion and (ii) opacity.

Inadequate collateral valuation practices early in the crisis led to significant losses and market disruptions later in the crisis.

To improve collateral valuation practices.

Policy Recommendations on Securities Lending and Repos

The FSB's policy recommendations on securities lending and repos are categorized in three broad groups: improvement in transparency (Section 2 of the Report); regulation of securities financing (Section 3 of the Report); and structural aspects of the securities financing markets (Section 4 of the Report).

Improvement in Transparency. The Report finds that, in order to be able to better detect risks in these markets, authorities need to augment their data collection so as to capture more granular and timely information on securities lending and repo exposures between financial institutions, including on the composition and evolution of the underlying collateral. The FSB envisions that national/regional authorities should decide the best way to collect the needed data, based on a consideration of their market structure and scale, and building upon existing data collection processes and market infrastructure where appropriate. The Report notes that the FSB has established a technical data experts group to develop proposed standards and processes by the end of 2014, in part through interacting closely with market participants. [\[4\]](#)

The Report makes four policy recommendations along these lines:

- Recommendation 1: Authorities should collect more granular data on securities lending and repo exposures amongst large international financial institutions with high urgency. Such efforts should to the maximum possible extent leverage existing international initiatives such as the FSB Data Gaps Initiative, taking into account the enhancements suggested in the Report. [\[5\]](#)
- Recommendation 2: Trade-level (flow) data and regular snapshots of outstanding balances (position/stock data) for repo markets should be collected. Regular snapshots of outstanding balances should also be collected for securities lending markets and further work should be carried out on the practicality and meaningfulness of collecting trade-level data. Such data should be collected frequently and with a high level of granularity, and should also capitalize on opportunities to leverage existing data collection infrastructure that resides in clearing agents, central securities depositories (CSDs) and/or central counterparties (CCPs).
- Recommendation 3: The total national/regional data for both repos and securities

lending on a monthly basis should be aggregated by the FSB which will provide global trends of securities financing markets (e.g. market size, collateral composition, haircuts, tenors). The FSB should set standards and processes for data collection and aggregation at the global level to ensure consistent data collection by national/regional authorities and to minimize double-counting at the global level. [6]

- Recommendation 4: The Enhanced Disclosure Task Force (EDTF) should work to improve public disclosure for financial institutions' securities lending, repo and wider collateral management activities, taking into consideration the items noted above. [7]

The Report makes a fifth policy recommendation that is specifically related to fund managers, that "authorities should review reporting requirements for fund managers to end-investors against the FSB's proposal, and consider whether any gaps need to be addressed." The January 2013 ICI Letter opposed the FSB's recommendations with respect to fund manager disclosure, arguing that it has little or no connection to systemic risk and that the FSB should defer to local authorities. Despite this comment, the FSB adopted the recommendation as proposed.

The Report suggests that the information that should be reported by fund managers to end-investors could include:

- Global data: the amount of securities on loan as a proportion of total lendable assets and of the fund's assets under management (AUM); and the absolute amounts of the repo book and the reverse repo book.
- Concentration data: Top 10 collateral securities received by issuer, top 10 counterparties of repo and securities lending (sources of borrowed cash, if applicable), and top 10 counterparties of reverse repo (sources of borrowed securities).
- Repo and securities lending data breakdowns: by collateral type, by currency, by maturity tenor, by geography (counterparty), cash versus non cash collateral, maturity of non-cash collateral and settlement/clearing (tri-party, CCP, bilateral).
- Reverse repo data breakdowns: by collateral type, by currency, by maturity tenor, by geography (counterparty), maturity of collateral.
- Re-use and re-hypothecation data: share of collateral received that is re-used or re-hypothecated, compared to the maximum authorized amount if any. Information on any restrictions on type of securities.
- Return data: split between the return from repos and securities lending and the return from cash collateral reinvestment.
- Number of custodians and the amount of assets held by each.
- The way securities received by the counterparty are held, i.e. in segregated accounts or pooled accounts.

Policy Recommendations Related to Regulation. The FSB makes three sets of policy recommendations relating to regulation, two of which are particularly germane to mutual funds: 1) cash collateral reinvestment, which is commonly used by U.S. mutual funds lending securities; 2) re-hypothecation and re-use of collateral; and 3) minimum regulatory standards for collateral valuation and management. Each of these is discussed below.

Cash collateral reinvestment. With respect to cash collateral reinvestment, the FSB adopted six high level principles and seven more granular principles covering risk-mitigation techniques, stress tests, and disclosure requirements. The principles were adopted substantially as proposed. [8] The attendant policy recommendation (Recommendation 6) states that "regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement

regulatory regimes meeting the minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.”

Requirement on re-hypothecation. The Report adopts two recommendations relating to re-hypothecation and re-use of client assets exactly as proposed in the 2012 Consultation.

Minimum regulatory standards for collateral valuation and management. The Report adopts three principles on collateral valuation and management by market participants that would serve as “minimum regulatory standards” for authorities to implement. Two of these were not controversial—recommendations that market participants should have contingency plans for the failure of their largest counterparties and that collateral should be marked-to-market at least daily with variation margin collected. They were adopted largely as proposed.

The other minimum regulatory standard was more controversial, and the final language in the Report differs in an important way from the proposal, as noted above. The FSB had proposed that “securities lending and repo market participants (and, where applicable, their agents) should only take collateral types that they are able following a counterparty failure to hold outright without breaching laws or regulations.” We disagreed with this principle insofar as it could have been interpreted to require money market funds, for example, to limit repo collateral to those instruments that are eligible securities under Rule 2a-7. The FSB changed this language in the Report. The final recommendation replaces the word “outright” with “for a period of time.” While the Report does not explain the reasons for the change, the final language is more consistent with provisions in Rule 2a-7 that are intended to promote an orderly disposition of holdings, including collateral securing a repo, following a default.

Policy Recommendations Related to Structural Aspects of the Securities Financing Market. The FSB’s final two recommendations address central clearing and the treatment of repos and securities lending transactions in bankruptcy. In both cases, the FSB concludes that no further regulatory or other action appears necessary. Its final recommendation on central clearing merely suggests that authorities should evaluate the costs and benefits of proposals to introduce CCPs. More pointedly, the recommendation with respect to bankruptcy states that changes to bankruptcy law treatment of repos and securities lending transactions simply “should not be prioritized for further work at this stage.”

Further Consultation: Proposed Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions

Annex 2 of the Report contains a second consultation related specifically to the concept of minimum haircuts for non-centrally cleared securities financing transactions. The Report proposes two principal recommendations:

- Proposed recommendation Annex 2-1 for public consultation: Regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral margins/haircuts, whether on an individual transaction or portfolio basis.
- Proposed recommendation Annex 2-2 for public consultation: Authorities should introduce a framework of numerical floors on haircuts for non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing against collateral other than government securities.

The minimum standards for methodologies used by market participants to calculate

haircuts are substantially restated from the 2012 Consultation. The FSB recommends that haircuts 1) should be based on the long-term risks of the assets used as collateral and be calibrated at a high confidence level in order to cover potential declines in collateral values during liquidation, and 2) should capture other risk considerations where relevant. The Report adds a new section (section 3, page 24) that describes additional guidance for market participants, such as prime brokers, that may calculate margins on a portfolio basis.

The proposed framework for numerical floors has changed significantly. The 2012 Consultation proposed two-tiers of numerical floors, one at high levels to be used in normal times and a lower level intended as a backstop to prevent excessive leverage. The Report replaces this with a single set of proposed numerical floors, at much lower levels than even the backstop levels in the 2012 Consultation, that would apply only to “non-centrally-cleared securities financing transaction in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing from financial entities subject to such regulation against collateral other than government securities.”

This chart shows a comparison of the 2012 Consultation’s proposed high level and backstop haircuts against those proposed in the Report:

Residual maturity of collateral Haircut level
Corporate and other issuers

Securitized products

Proposed High Level Proposed Backstop Level Current Proposed Level Proposed High Level
Proposed Backstop Level Current Proposed Level
≤ 1 year debt securities, and FRNs

1%

0.5%

0.5%

2%

1%

1%

> 1 year, ≤ 5 years debt securities

4%

2%

1%

8%

4%

2%

> 5 years debt securities

8%

4%

2%

16%

8%

4%

Main index equities

15%

7.5%

4%

15%

7.5%

4%

Other assets within the scope of the framework

25%

12.5%

7.5%

25%

12.5%

7.5%

The Report explains that the FSB believes these proposed numerical floors would “not be unduly restrictive,” and “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 every single circumstance, considering all relevant risk factors.”

As in the 2012 Consultation, the proposed framework of numerical haircut floors is intended to apply only to transactions where the primary motive is to provide financing (e.g., repos). Securities lending transactions are proposed to be exempt.

Comments are due in response on November 28, 2013. The Report notes that following this consultation, the FSB intends to complete its work on minimum haircut standards in the spring of 2014.

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endnotes

[1] The FSB was established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It brings together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Information about the FSB is available at <http://www.financialstabilityboard.org>.

[2] Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Financial Stability Board (November 18, 2012), available at http://www.financialstabilityboard.org/publications/r_121118b.pdf. ICI's comment letter on the 2012 Consultation can be found at http://www.financialstabilityboard.org/publications/c_130129at.pdf (the "January 2013 ICI Letter"). The FSB's initial discussion paper on this topic was published earlier in 2012. See Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report of the FSB Workstream on Securities Lending and Repos, available at http://www.financialstabilityboard.org/publications/r_120427.pdf. ICI's comment letter on the interim report can be found at https://www.financialstabilityboard.org/publications/c_120806p.pdf (the "2012 ICI Letter").

[3] Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Financial Stability Board (August 29, 2013), available at http://www.financialstabilityboard.org/publications/r_130829b.htm.

[4] The creation of the technical data experts group is along lines recommended by ICI. The January 2013 ICI Letter supported a globally harmonized approach to the collection of data by regulators, but also suggested that the process by which regulators gather data will need to be developed through further consultations with industry and a careful review of existing processes and available information.

[5] The January 2013 ICI Letter supported the FSB's efforts to ensure that authorities have the information they need to effectively monitor securities lending and repo markets for systemic risks, but offered three principles to guide regulators in gathering data, recommending that authorities should: (1) request only the information they need to monitor for systemic risks in the markets; (2) gather that information in the most efficient way reasonably available; and (3) have appropriate systems and procedures in place to ensure the confidentiality and security of such information before requesting it from market participants.

[6] Although the Report addresses the collection of aggregated data by the FSB, it does not

appear to address the public release of that data. The January 2013 ICI Letter generally supported the public release of data on an aggregated basis, to the extent such disclosure advances the goal of mitigating systemic risk. That said, we strongly opposed the public disclosure of the economic terms of securities lending transactions, such as fee splits.

[7] The January 2013 ICI Letter opposed the FSB's recommendations with respect to corporate disclosure, arguing that the FSB should defer to local authorities on this types of disclosure, which has little or no connection to systemic risk. It is worth noting, however, that the Report does not make specific recommendations in this regard, but rather makes recommendations for further work by the EDTF.

[8] The 2013 ICI Letter supported adoption of the principles, which are broadly consistent with U.S. collateral practices, but requested clarification that the principle that "securities lending cash collateral reinvestment should be conducted with one of the primary objectives being capital preservation" allowed for investment in funds that seek a reasonable rate of return generally consistent with capital preservation. The final Report adopted this principle as proposed, without our requested clarification.