MEMO# 26164

May 18, 2012

Draft ICI Letter on FSB Report on Securities Lending and Repos; Member Input Requested by Wednesday, May 23

[26164]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 16-12
INTERNATIONAL COMMITTEE No. 16-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 33-12
SEC RULES COMMITTEE No. 30-12 RE: DRAFT ICI LETTER ON FSB REPORT ON SECURITIES LENDING AND REPOS; MEMBER INPUT REQUESTED BY WEDNESDAY, MAY 23

As you know, the Financial Stability Board (FSB) has published a report from its workstream on securities lending and repurchase agreements that identifies a number of issues that in the FSB's view might pose risks to financial stability. [1] The report, along with any comments received, will form the basis for the FSB's policy recommendations on ways that regulators around the world might strengthen the regulation of securities lending and repos. Those policy recommendations are expected by the end of the year.

Member Input Requested by May 23

A draft of ICI's comment letter on the report is attached and briefly summarized below. Comments are due to the FSB on Friday, May 25. Accordingly, we are asking ICI members for their input on the draft by the close of business on Wednesday, May 23. Please provide any comments on the draft letter to me at 202/371-5430 or rcg@ici.org.

Summary of ICI's Letter

The draft letter attempts to address the financial stability issues highlighted in the report, first from the perspective of U.S. funds lending securities, and then from the perspective of U.S. money market funds participating in repo financing. It then addresses the FSB's concerns about the potential for securities lending and repo financing to influence the level of risk-taking within the financial system in a procyclical way.

Securities Lending

The letter explains that, like many other types of institutional investors, mutual funds, closed-end funds, and exchange-traded funds may engage in securities lending, subject to guidelines established by the staff of the Securities and Exchange Commission.

The letter then addresses several financial stability issues highlighted in the report, including concerns over transparency in the securities lending market, collateral re-use or re-hypothecation, the potential for a “fire sale” of collateral assets, potential risks from indemnification by agent lenders, and the risk of insufficient rigor in the valuation of collateral assets. The overarching theme that runs throughout this portion of the draft letter is that many of the SEC staff’s guidelines and related SEC rules directly address the FSB’s financial stability concerns.

Repo Financing

The draft letter explains that many U.S. money market funds participate as cash investors in tri-party repos. It then describes the recent work by the Task Force on Tri-Party Repo Infrastructure, on which ICI and several ICI members participated, and the areas in which significant progress was made to meaningfully reduce both the potential for systemic risk and the magnitude of the risk associated with the tri-party repo infrastructure. The letter argues that these developments help address and mitigate many of the potential financial stability concerns with repo financing.

Procyclicality

The report expresses a concern that there is potential for securities lending and repo financing to influence the level of risk-taking within the financial system in a procyclical way. The draft letter suggests that the participation by U.S. funds in either securities lending or tri-party repo may raise fewer concerns in this area because U.S. funds typically take cash collateral for securities lending, using a standard and stable haircut of 102% for domestic securities or 105% for foreign securities, and reinvest in highly liquid money market funds or similar collateral investment vehicles that are marked-to-market daily and maintained for the fund (i.e., not re-hypothecated). Similarly, U.S. money market funds mark-to-market holdings daily and do not re-hypothecate the collateral received in tri-party repo.

The letter also expresses our belief that U.S. fund participation in securities lending or repo did not play a significant procyclical role in the financial crisis, and cautions the FSB to carefully consider the potential for unintended consequences that might come from policy recommendations designed to limit procyclicality.

Robert C. Grohowski
Senior Counsel
Securities Regulation - Investment Companies

Attachment

endnotes

[1] See Memorandum No. 26121, dated May 1, 2012. The report is entitled “Securities Lending and Repos: Market Overview and Financial Stability Issues,” and is available at http://www.financialstabilityboard.org/publications/r_120427.pdf.