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FSB Publishes Reports on the Re-Hypothecation of Client Assets and Collateral Re-Use

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Trading and Markets RE: FSB Publishes Reports on the Re-Hypothecation of Client Assets and Collateral Re-Use

FSB recently published two reports relating to its ongoing work on the potential systemic risks raised by securities financing transactions (“SFTs”), such as securities lending and repurchase (“repo”) transactions. The first report follows up on FSB’s prior recommendation to consider the harmonization of client asset rules relating to re-hypothecation and collateral re-use,[\[1\]](#) while the second report adopts measures of non-cash collateral in order to allow monitoring of the re-use of collateral in SFTs.[\[2\]](#) These reports follow an August 2013 FSB report (“FSB August 2013 Report”)[\[3\]](#) which set out FSB’s policy recommendations for addressing financial stability risks in relation to securities lending and repos, and a November 2015 report on standards and processes for global securities financing data collection and aggregation, which FSB followed up with a 2016 consultation on collateral re-use measures, metrics, and related data elements.[\[4\]](#) The report on re-hypothecation and collateral re-use describes potential financial stability issues associated with re-hypothecation of client assets and collateral re-use, and explains the evolution of market practices and current regulatory approaches relating to these practices. The report on non-cash collateral re-use finalizes the measures and metrics of non-cash collateral re-use with respect to SFTs that authorities will monitor for financial stability purposes. A summary of the two reports is provided below.

Re-Hypothecation and Collateral Re-Use: Potential Financial Stability Issues, Market Evolution, and Regulatory Approaches

The FSB August 2013 Report recommended that FSB establish an expert group to examine possible harmonization of client asset rules relating to re-hypothecation. This

recommendation led to the formation of the FSB Re-hypothecation and re-use Experts Group (“REG”), which was tasked with collecting current regulatory approaches on re-hypothecation of client assets and examining possible harmonization. REG’s mandate also included review of possible financial stability issues related to collateral re-use more generally. The findings by the REG were reviewed and endorsed by the FSB Plenary in November 2016, and are summarized in the re-hypothecation and collateral re-use report.

Conceptual definitions of re-hypothecation of client assets and collateral re-use

FSB defines re-hypothecation narrowly, for purposes of the report, as “any use of client assets by a financial intermediary.” By contrast, FSB defines collateral re-use as not limited to client assets and broadly including “any use of assets delivered as collateral in a transaction by an intermediary or collateral taker.” The report enumerates various benefits of re-hypothecation and collateral re-use noting, among others, the following: (i) an increase in lending capacity while lowering funding costs for both financial intermediaries and their clients; (ii) a reduction in the costs associated with long and short positions in equities and other securities; (iii) a mitigation of pressures on collateral supply that may be associated with increased posting of initial margin pursuant to OTC derivatives or SFTs; (iv) enhanced market functioning under normal and stressed conditions; and (v) the proper implementation of monetary policy.

Potential financial stability issues in relation to re-hypothecation of client assets and collateral re-use

FSB believes, however, that re-hypothecation of client assets and collateral re-use may also pose potential financial stability issues. The potential risks FSB identifies in the report include: (i) obstacles to clients accessing their securities; (ii) regulatory arbitrage in case of non-harmonized re-hypothecation regimes; (iii) the build-up of leverage in the financial system; (iv) the risk that clients may be more likely to opt out of re-hypothecation programs (where permitted) or transfer assets in a manner that potentially amplifies funding strains and creates operational and other risks when there are concerns about the financial condition of an intermediary; (v) enhanced interconnectedness from chains of transactions involving the re-use of collateral;^[5] (vi) the risk that re-use of collateral may contribute to pro-cyclicality in the financial sector, and (vii) the risk that the re-use of collateral may amplify risks related to sudden decreases in the value of securities that are used and accepted as collateral.

Recent experience and evolution in market practices and regulations with respect to re-hypothecation and collateral re-use

The report discusses market participants’ experiences with re-hypothecation and collateral re-use during the 2007-09 financial crisis and subsequent periods of market stress, and highlights changes in market practice and regulation that have occurred since that time. FSB believes that these changes may address certain vulnerabilities and risks that were exposed by the financial crisis. FSB notes, for example, significant reform efforts undertaken in the United States with respect to the tri-party repo market,^[6] enhancements adopted by the SEC to disclosure requirements for funds’ securities financing activities in the United States, EU customer protection requirements under the MiFID II regime, and prudential regulatory reforms applicable to banks, including the Basel III framework. Additionally, FSB notes recent market and behavioral changes relating to re-hypothecation and collateral re-use, including changes to documentation and record-keeping, heightened due diligence and operational changes, and enhanced risk and collateral management

practices.[\[7\]](#)

Possible harmonization of regulatory approaches related to re-hypothecation of client assets

FSB states that the main goal of the regulation of re-hypothecation is to protect investors from harm that can occur when a financial intermediary that has re-hypothecated client securities faces financial distress. FSB explains that, in the wake of the financial crisis, it has focused on improving safeguards regarding the re-hypothecation of client assets, as well as considering the potential harmonization of client asset rules with respect to re-hypothecation.

The report outlines key elements of regulation of re-hypothecation that generally are found across member jurisdictions. These elements include: (i) a requirement that financial intermediaries disclose to the client their intent to re-hypothecate the client's assets and obtain the client's consent before doing so; (ii) a requirement that financial intermediaries provide clients and/or regulators with daily reports of the locations of client assets; (iii) prohibiting or restricting the use of client assets by the financial intermediary holding the assets in custody; (iv) alternatives to traditional creditor treatment for investors in the event of an intermediary bankruptcy; and (v) capital and liquidity regulations for financial intermediaries permitted to re-hypothecate client assets.

The report on re-hypothecation and collateral re-use focuses on several existing approaches to regulation of re-hypothecation, specifically the US approach, which is governed by the Securities Exchange Act of 1934, and the EU approach, which is governed primarily by MiFID II. After reviewing these approaches, FSB concludes that all regulatory approaches to re-hypothecation are designed to protect client assets, and that differences in approach between the US and EU approaches can be explained primarily based on the broader regulatory and legal contexts in each jurisdiction.

Based on a recommendation in the FSB August 2013 Report, FSB analyzes the pros and cons of recommending that regulatory approaches to re-hypothecation be harmonized. FSB highlights possible merits of harmonization, including: (i) a potential decrease in opportunities for regulatory arbitrage; (ii) the promotion of a more level playing field in the cross border context; and (iii) enhanced transparency of client asset protection standards, because harmonization may increase clients' understanding of the treatment of their assets in various jurisdictions.

FSB concludes, however, that harmonization of regulatory approaches to re-hypothecation is not necessary at this time. It rests its conclusion largely on the basis that Recommendation 7 of the FSB August 2013 Report,[\[8\]](#) which sets out common principles for regulations governing re-hypothecation, has been at least partially implemented in REG member jurisdictions, resulting in some key similarities among jurisdictions.[\[9\]](#) FSB also notes several significant operational challenges to harmonizing regulatory approaches to re-hypothecation, including: (i) the correlation between regulatory approaches to re-hypothecation and securities and insolvency laws, as well as market structures, which are very different among jurisdictions; (ii) individual jurisdictions pursue different rationales in the design of re-hypothecation laws and regulations; (iii) different financial intermediaries have different funding models; and (iv) other laws and regulatory regimes directly impact the suitability of specific measures to implement re-hypothecation rules. FSB encourages its member jurisdictions to continue to implement Recommendation 7 of the FSB August 2013 Report, as it serves to provide a common basis for the design of regulations with

respect to re-hypothecation of client assets.

Addressing residual financial stability risks associated with collateral re-use

Following its conclusion that there is no immediate case for harmonizing regulatory approaches to re-hypothecation of client assets, FSB makes recommendations to address what it believes are residual financial stability risks associated with collateral re-use.

First, it recommends further monitoring of collateral re-use activities. It explains that it has developed measures of collateral re-use for SFTs, with the goal of producing global aggregates of re-use activity through potential inclusion in FSB's global securities financing data standards. FSB considers the successful completion of this initiative to be an important step to obtain a clearer understanding of global (and national/regional) collateral re-use activities in the securities financing markets. FSB also notes important national and academic initiatives to develop an overview of collateral re-use activities, including the Securities Financing Transactions Regulation in the EU, and the SEC's new data reporting rules in the United States for registered investment companies.

Second, FSB encourages national and regional authorities to consider monitoring collateral re-use activities beyond SFTs, as appropriate.

Non-Cash Collateral Re-Use: Measure and Metrics

The report on non-cash collateral re-use represents the conclusion of the FSB February 2016 Consultation. The measure and metrics of non-cash collateral re-use for SFTs that FSB identifies in this report will be used by national and regional authorities to monitor for financial stability purposes, prior to the starting date of the FSB data collection exercise in January 2020, as part of its global securities financing data standards.

Scope of Collateral Re-use Measure

The scope of collateral re-use FSB seeks to measure is restricted to collateral received and subsequently re-used in SFTs. However, FSB encourages authorities to consider monitoring collateral re-use activities beyond SFTs as appropriate. FSB will monitor market developments to ensure that the SFT-only scope of the collateral re-use measure remains adequate.

Collateral re-use measure at the national/regional level

The FSB February 2016 consultation considered three alternative measures of collateral re-use: an exact measure, an approximate measure, and an indirect approximate measure. Based on market participants' comments, FSB decided to adopt the approximate measure of collateral re-use and to include it in its global securities financing data standards. The approximate measure of collateral re-use would require market participants to rely on granular data on their own assets and to distinguish between collateral received that is eligible and ineligible for re-use. Therefore, the approximate measure of collateral re-use by individual entities is calculated using data on total own assets, collateral received that is eligible for re-use, and collateral posted.

Collateral re-use metrics

The report discusses various metrics related to re-use of collateral that are intended to provide a more in-depth assessment of market characteristics that have been linked to financial stability risks (e.g. interconnectedness, degree of concentration). FSB explains

that these metrics include an aggregated measure of collateral re-use at the jurisdiction and global level, collateral re-use rate, share of re-used collateral, concentration of re-use activities, and collateral circulation length. These measures can also be calculated for specific asset types typically used as collateral as well as for other relevant breakdowns.

Data architecture and data elements to be submitted to the FSB

The report explains how FSB intends that data will be collected and transmitted from reporting entities to the national/regional authority (first tier) and then from the national/regional authority to the FSB (second tier). For the first tier, the design (e.g. reporting at entity or transaction level) and granularity of the data collection in each jurisdiction will remain the responsibility of the relevant national/regional authority, as is the case for the data collection on SFTs. For the second tier, the authorities will add up the collateral re-used for entities belonging to the same reporting sector so as to obtain the breakdowns along this dimension.

Next Steps

FSB members currently are working on detailed operational arrangements to initiate the official data collection and aggregation, beginning with year-end 2018 data.^[10] FSB notes that authorities in several jurisdictions are also launching legislative and/or data collection initiatives to better understand their securities financing markets and improve market transparency. In the United States, for example, the Office for Financial Research has launched a pilot project to fill gaps in data with a focus on bilateral repo markets^[11] and securities lending markets.^[12] The EU has adopted a regulation requiring SFTs to be reported to a trade repository.^[13] FSB will collect collateral re-use measures and metrics based on this report from January 2020 and will work on the detailed operational arrangements for collecting these data through its Data Experts Group. FSB explains that it understands the need to continue to monitor the scope and methodology for measuring collateral re-use in light of evolving market practices, and therefore plans to review the scope, measure and metrics of collateral re-use five years after the launch of the global data collection of collateral re-use measures, with a continued discussion with market participants as appropriate.

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endnotes

[1] Financial Stability Board, *Re-hypothecation and collateral re-use: Potential financial stability issues, market evolution and regulatory approaches* (January 25, 2017), available at <http://www.fsb.org/wp-content/uploads/Re-hypothecation-and-collateral-re-use.pdf> (“report on re-hypothecation and collateral re-use”).

[2] Financial Stability Board, *Non-Cash Collateral Re-Use: Measure and Metrics* (January 25, 2017), available at <http://www.fsb.org/wp-content/uploads/Non-cash-Collateral-Re-Use-Measures-and-Metrics.pdf> (“report on non-cash collateral re-use”).

[3] Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (August 29, 2013), available at http://www.financialstabilityboard.org/publications/r_130829b.htm. For the summary of the FSB August 2013 Report, please see ICI Memorandum No. 27560 (September 12, 2013), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo27560>.

[4] Financial Stability Board, *Standards and Processes for Global Securities Financing Data Collection and Aggregation* (November 18, 2015), available at <http://www.fsb.org/wp-content/uploads/FSB-Standards-for-Global-Securities-Financing-Data-Collection.pdf>; Financial Stability Board, *Transforming Shadow Banking into Resilient Market-based Finance: Possible Measures of Non-Cash Collateral Re-Use* (February 23, 2016), available at <http://www.fsb.org/wp-content/uploads/Report-on-possible-measures-of-non-cash-collateral-reuse.pdf> (“FSB February 2016 Consultation”).

[5] FSB recognizes, however, that for US registered funds, cash collateral reinvestment in the securities lending context typically does not extend beyond the instrument in which such investment is made.

[6] Specifically, FSB notes that these efforts, which were initiated by a task force sponsored by the Federal Reserve Bank of New York, “have made the potential financial stability risks associated with the tri-party repo market . . . ‘less immediate,’ in line with the goal of the tri-party repo reform efforts to reduce systemic risk.” Report on re-hypothecation and collateral re-use, *supra* note 1, at 13. For example, FSB notes that the share of tri-party repo volume that is financed with intraday credit from a clearing bank has dropped from 100% as recently as 2012, to a level averaging between 3-5%. *Id.* at n. 30.

[7] In this regard, FSB notes that market participants described an increased sensitivity about the quality and liquidity of collateral, both in the securities lending and repo markets. For example, in the securities lending markets, there has been less use of corporate bonds and asset-backed securities. FSB recognizes, however, that US registered funds are limited, by SEC regulation, to accepting as collateral cash, US government securities, and letters of credit.

[8] Recommendation 7 states that: (i) financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary; (ii) client assets may be re-hypothecated by an intermediary for the purpose of financing client long positions and covering short positions, but they should not be re-hypothecated for the purpose of financing the intermediary’s own-account activities, and (iii) only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

[9] See Annex 2 to the report on re-hypothecation and collateral re-use, *supra* note 1 (Current status of implementing Recommendation 7 of the FSB August 2013 Report).

[10] Pursuant to the timeline set out in the global securities financing data standards published in 2015. See *supra* note 4.

[11] Office for Financial Research, *The U.S. Bilateral Repo Market: Lessons from a New Survey* (January 13, 2016), available at

https://www.financialresearch.gov/briefs/files/OFRbr-2016-01_US-Bilateral-Repo-Market-Lessons-from-Survey.pdf.

[12] Office for Financial Research, *A Pilot Survey of Agent Securities Lending Activity* (August 23, 2016), *available at* https://www.financialresearch.gov/working-papers/files/OFRwp-2016-08_Pilot-Survey-of-Securities-Lending.pdf

[13] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of re-use. The European Securities and Markets Authority (ESMA) published a Consultation Paper on these standards as part of its consultations on Level 2 measures under the Securities Financing Transactions Regulation (EU 2015/2365). The final report and the draft technical standards should be submitted to the European Commission for endorsement by the first half of 2017.

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