MEMO# 26121

May 1, 2012

FSB Requests Comment on Report on Securities Lending and Repos by May 25; Member Call Scheduled For Monday, May 7

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 15-12
INTERNATIONAL COMMITTEE No. 15-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 31-12
SEC RULES COMMITTEE No. 29-12 RE: FSB REQUESTS COMMENT ON REPORT ON SECURITIES LENDING AND REPOS BY MAY 25; MEMBER CALL SCHEDULED FOR MONDAY, MAY 7

As you may be aware, the Financial Stability Board (FSB) [1] has launched a number of workstreams seeking to develop policy recommendations to strengthen the regulation of the so-called "shadow" banking system. [2] One of these workstreams focuses on securities lending and repurchase agreements (repos).

Last week, the FSB published a report from that workstream, summarized briefly below, that identifies a number of issues that, in the FSB's view, might pose risks to financial stability. [3] 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.

ICI is considering whether to comment on the report. Although the FSB does not have direct regulatory authority over US funds, its work reflects input from the Securities and Exchange Commission and the Federal Reserve Bank of New York. Accordingly, its policy recommendations could have an impact on future US regulatory policy decisions.

Member Call

The FSB has requested comment on the report by May 25. We have scheduled a call for 3:00 p.m. Eastern time on Monday, May 7, to discuss the report and the issues identified by the FSB. The dial-in number for this call is 1-888-455-4268 and the pass code is 66465. If you are unable to participate in the call but have thoughts on the report, please contact me at rcg@ici.org or (202) 371-5430.

Summary of the Report

The report contains five sections and several annexes that include additional detailed information. Sections 1 and 2 provide an overview of securities lending and repo markets globally, including the main "drivers" of the markets. In its overview, the FSB divides the securities financing markets into four segments: (i) a securities lending segment; (ii) a leveraged investment fund financing and securities borrowing segment; (iii) an inter-dealer repo segment; and (iv) a repo financing segment.

Section 3 discusses places securities lending and repo markets in the wider context of the FSB's work on the "shadow" banking system. In this section, the FSB appears to focus on ways in which securities lending and/or repo financing could raise leverage or maturity transformation concerns, "chains of transactions" that might result from short sales, and so-called "collateral downgrade/upgrade" transactions.

Section 4 provides an overview of existing regulatory frameworks for securities lending and repos.

Section 5 may be the most likely part of the report for ICI to comment upon. This section identifies seven issues posed by these markets that regulators might consider from a financial stability perspective:

1. A perceived lack of transparency. The report notes that securities financing markets are complex, rapidly evolving, and "can be opaque for some market participants and policymakers." It states that it may be appropriate to consider, from a financial stability perspective, whether transparency could be improved at the macro-level (with increased market data), micro-level (with increased transaction data), corporate disclosure level (with greater on-balance sheet reporting required), and/or increased risk reporting by intermediaries to their clients (particularly with respect to the rehypothecation of collateral and collateral reinvestment risks).
2. A perceived "procyclicality" of leverage and interconnectedness in the system. The report notes that securities financing markets may allow financial institutions (including some non-banks) to obtain leverage in a way that is sensitive to the value of the collateral as well as their own perceived creditworthiness. It states that, as a result, these markets can influence the leverage and level of risk-taking within the financial system in a procyclical and potentially destabilizing way.
3. Other potential financial stability issues associated with collateral reuse. The report suggests that the reuse of collateral, whether arising from repo, securities lending, rehypothecation of customer assets, or margining of OTC derivatives, creates the potential for increased interconnectedness among firms and higher leverage.
4. Potential risks arising from the "fire sale" of collateral assets. The report states that, as seen during the financial crisis, collateral "fire sales" may lead to market turmoil. It notes that individual market participants that establish appropriate risk management requirements or operate under regulatory exposure limitations (e.g., collateral credit quality, counterparty limitations, diversification, and haircuts) can mitigate exposure on their own secured transactions with a particular counterparty, but lack the visibility to assess that counterparty's aggregate transactions and collateral pool across the

market and assess the overall market impact of a default.

5. Potential risks arising from agent lender practices. The report states that many agent lenders offer indemnities to their customers against the risk of borrower default. It suggests that there is a need to consider "what consequences different market practices in relation to indemnities have for incentives to manage risks" and whether these consequences have any implications for market stability. For example, the report suggests that an indemnification could lead to the lender looking to the agent lender as its effective counterparty, and thus reduce incentives for the lender to screen and monitor the borrower.
6. "Shadow banking" through cash collateral reinvestment. The FSB states that "by reinvesting cash collateral received from securities lending transactions, any entity with portfolio holdings can effectively perform 'bank-like' activities, such as credit and maturity transformation, thereby subjecting its portfolio to credit and liquidity risks." The report further suggests that this may give rise to the risk of a "run" if securities borrowers start terminating the securities lending transactions and ask for their cash collateral to be returned.
   We would like to highlight, in particular, one statement in this section of the report. It notes that collateral may be reinvested in "commingled funds," which it defines to include money market funds and other registered investment companies. It then states that these funds "offer less control and transparency than separate accounts and may create an incentive for clients to 'run' first in the event of any problems." It also notes that "market participants told the [FSB] that an increasing number of clients are moving towards separate accounts and the number of commingled funds has decreased significantly since the crisis."
7. "Insufficient rigor" in collateral valuation and management practices. The report states that a number of financial institutions around the world did not mark-to-market their reinvested collateral or based valuation decisions on "prices generated by overly-optimistic models."

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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] See Memorandum No. 25637, dated November 11, 2011.

[3] 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. A press release accompanying the report is available at http://www.financialstabilityboard.org/press/pr_120427.pdf.