

FSB

FINANCIAL  
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BOARD

# FSB Shadow Banking Task Force

## Regulation of securities lending/repo

## **Workstream on Securities Lending and Repos**

- One of the five workstreams under the Financial Stability Board (FSB) Shadow Banking Task Force

### **The Workstream published its interim report in April 2012, which**

- Provided an overview of the securities lending market;
- Described their locations within the shadow banking system; and
- Discussed the financial stability issues arising from practices in these markets

### **The Workstream published a public consultative document in November 2012, which includes 13 policy recommendations on**

- Transparency
- Regulation
- Structure

## Securities lending

- Typically, financial institutions borrow securities to cover short sales (including for clients) and asset managers lend securities to enhance return.
- The securities loan can be collateralised by cash or securities. In case of cash collateral, the securities lender reinvests the cash (often through an agent) in money market instruments.
- Total securities on loan globally: \$1.8 trillion

## Repo

- Repurchase agreements (repos) are typically used by banks and other financial institutions to obtain secured funding
- At the beginning of a repo, the cash borrower sells securities with a simultaneous agreement to repurchase equivalent securities at a future date for the original value plus a repo rate
- Total size: US (\$2.1-2.6 trillion excluding CCP), Europe (\$8.3 trillion), Japan (\$2.4 trillion), Canada (\$218 billion)

# Financial stability risks in securities lending and repo markets

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## Pure shadow banking risks

- Using repo to create short-term, money-like liabilities, facilitating credit growth and maturity/liquidity transformation outside the banking system ;
  - The policy goal is to ensure sufficient transparency to the authorities and limit risks to financial stability from excessive leverage and maturity transformation
- Securities lending cash collateral reinvestment;
  - The policy goal is to subject cash collateral reinvestment to regulatory limits on liquidity and leverage risks

# Financial stability risks in securities lending and repo markets (cont'd)

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## Risks that span banking and shadow banking

- Tendency of secured financing to increase procyclicality of system leverage;
  - The policy goal is to restrict, or put a floor on the cost of, secured 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
- Risk of a fire sale of collateral securities;
  - The policy goal is 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

# Financial stability risks in securities lending and repo markets (cont'd)

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## Risks that span banking and shadow banking (cont'd)

- Re-hypothecation of unencumbered assets
  - The policy goal is 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 reuse of collateral
  - The policy goal is to reduce the risk of financial contagion and opacity.
- Inadequate collateral valuation practices
  - The policy goal is to improve collateral valuation standards

## **Improvement in regulatory reporting**

- More granular data on securities lending and repo exposures amongst large international financial institutions

## **Improvement in market transparency**

- Feasibility studies for trade repositories
- Market wide surveys as an interim step

## **Improvement in corporate disclosures**

- Public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities

## **Improvement in reporting by fund managers to end-investors**

- Reporting requirements for fund managers to end-investors

## Minimum haircuts

- Key principle: Minimum haircuts may limit the build-up of excessive leverage and reduce procyclicality in the financial system via the financing of risky assets, in particular by entities not subject to prudential regulation.
- Standards for methodologies used by market participants to calculate haircuts
  - Haircuts should be based on the long-run risk of collateral and be calibrated at a high confidence level
  - Haircuts should capture other risk considerations, e.g. concentration and wrong-way risk

## Minimum haircuts (cont'd)

- Numerical floors
  - Two broad approaches: high level and back-stop level
  - Scope
    - Transaction type (financing transactions vs. lending/borrowing of securities)
    - Counterparty type (all market participants vs. exposures of regulated financial intermediaries to other entities and exposures amongst other entities vs. exposures of regulated financial intermediaries to other entities)
    - Collateral type (possible exclusion of sovereign bond repos)
  - Implementation (firm-specific regulation vs. market regulation)
  - The FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets and should consult on whether a framework of numerical floors would be effective and workable in achieving the

## Minimum standards on cash collateral reinvestment

- Key principle: The proposed minimum standards should focus on limiting risks arising from cash collateral reinvestment, in particular liquidity risk.
- Scope: all financial entities that are engaged, with or without an agent, in securities lending against cash collateral where the cash collateral is reinvested in a portfolio of assets.
- Draft proposed requirements on
  - (i) high-level principles
  - (ii) mitigating liquidity, credit, and other risks associated with cash collateral reinvestment
  - (iii) stress tests
  - (iv) disclosure requirements

## Requirement on re-hypothecation

- Definition: “re-use” includes any use of securities delivered in one transaction in order to collateralise another transaction; “re-hypothecation” is defined more narrowly as re-use of client assets.
- Regulations should address the following principles
  - 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;
  - In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and
  - Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.
- An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation

## Minimum regulatory standards for collateral valuation and management

- WS5 proposes the following principles:
  - 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: (i) hold outright without breaching laws or regulations; (ii) value; (iii) risk manage; and (iv) liquidate in an orderly way.
  - Securities lending and repo market participants (and, where applicable, their agents) should have contingency plans for the failure of their largest market counterparties, including in times of market stress. These plans should include how they would manage the collateral following default.
  - Collateral and lent securities should be marked to market at least daily and variation margin collected at least daily where amounts exceed a minimum acceptable threshold.

## Central clearing

- Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.

## Changes to bankruptcy law treatment of repo and securities lending transactions

- Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.

# Annex 1: Proposed policy recommendations on securities lending and repos

**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 Group, taking into account the enhancements suggested by the Workstream.

**Recommendation 2:** Trade repositories (TRs) are likely to be the most effective way to collect comprehensive repo and securities lending market data. The FSB should consult on the appropriate geographical and product scope of such TRs. The FSB should encourage national/regional authorities to undertake feasibility studies for the establishment of TRs for individual repo and securities lending markets, as well as coordinate and facilitate those efforts. Depending on the consultation findings on the appropriate geographical and product scope of TRs, the FSB should establish a working group to identify the appropriate scope and undertake a feasibility study for one or more TRs at a global level. Such feasibility studies should involve market participants.

**Recommendation 3:** As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such market-wide surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.

**Recommendation 4:** The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities as needed, taking into consideration the items noted above.

**Recommendation 5:** Authorities should review reporting requirements for fund managers to end-investors in line with the proposal by the Workstream.

**Recommendation 6:** Regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral haircuts. Those guidelines should seek to minimise the extent to which these methodologies are pro-cyclical. Standard setters (e.g. BCBS) should review existing regulatory requirements for the

# Annex 1: Proposed policy recommendations on securities lending and repos (cont'd)

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**Recommendation 7:** In principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets. The FSB should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives. This would include consultation on the levels and the scope of application of such framework by counterparty, collateral, and transaction type (see sections 4.1.4 - 4.1.5).

**Recommendation 8:** Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.

**Recommendation 9:** Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:

- 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;
- In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and
- Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

**Recommendation 10:** An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation.

**Recommendation 11:** Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.

**Recommendation 12:** Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.