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Shadow banking risks in securities lending and repos

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On 29 August 2013, the Financial Stability Board (FSB) published its policy recommendations in its paper “Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos” concerning strengthening oversight and regulation of shadow banking activities in the securities lending and repo markets (“repo” being shorthand to describe a “repurchase transaction”) (the “Recommendations”).

The Recommendations follow the FSB’s initial proposals to strengthen oversight and regulation of the shadow banking system in its report to the G20 in October 2011, and its consultative document issued in November 2012.

In very broad terms, one can describe shadow banking as the provision of banklike services outside the regular banking system. Whilst entities operating in the regular banking system are subject to prudential regulation and other safeguards, the world of non-bank entities engaging in similar activities is generally subject to more limited oversight. The FSB has identified two such shadow banking activities as securities lending and repos.

The main driver for the FSB’s consultation process is the notion that securities lending and repo transactions can create, or add to, instability in financial markets. Repo transactions provided a significant source of funding for banks in the lead up to the financial crisis of 2008. Repo transactions are generally short-dated, and when repo financing suddenly ceases to be available, funding problems can be exacerbated. Regulators had insufficient visibility on the repo market because it includes non-bank financial institutions subject to a different regulatory framework, and one of the key themes in the Recommendations is increased transparency allowing regulators and central banks to more closely monitor these markets. The counterweight to the imposition of a restrictive regulatory framework is a recognition that securities lending and repo play crucial roles in providing financing and liquidity, and that the FSB’s proposals should be aimed at managing, rather than curtailing, these activities. This article examines several of the key proposals in the Recommendations.

THE FSB

The FSB was “established in 2009 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”. The ultimate goal of the Recommendations is a consistent adoption and implementation of a regulatory framework by various central banking and regulatory authorities around the world, applying broadly consistent obligations on markets and their participants. The FSB’s members comprise central banks and regulators around the world.

SECURITIES LENDING AND REPO TRANSACTIONS IN PRACTICE

From a contractual perspective, securities lending transactions and repo transactions work in much the same way. Securities lending transactions involve a lender transferring title to securities to a borrower in return for receiving collateral, which may comprise securities or cash. These are supposed to be fully-collateralised transactions, with the main driver for the transaction being that a borrower wishes to borrow securities of a certain kind (eg, to sell those securities “short”). Either lender or borrower can choose when the borrowed securities are to be returned to the lender (with the collateral to be returned to the borrower at the same time), hence these are “on demand” transactions. Large asset managers often lend out large quantities of securities, typically through custodians as agent lenders, and reinvest cash collateral. Repo transactions, on the other hand, have traditionally been seen as effectively secured lending transactions, the main driver being that a party (called the seller) wishes to raise cash by providing securities as collateral for the loan, subject to an obligation to “repurchase” the securities at the expiry of the transaction. From a contractual perspective, the key difference between repo transactions and securities lending transactions is that repo transactions are for a fixed term, whereas securities lending transactions are “on demand”. Whilst the commercial purpose and economics of these transactions are quite different, the two markets are based upon very similar contractual arrangements. Securities lending transactions are typically governed by a market standard securities lending agreement such as the Global Master Securities Lending Agreement published by the International Securities Lending Association. Repo transactions are typically governed by a market standard agreement such as the Global Master Repurchase Agreement currently published by the Securities Industry and Financial Markets Association and International Capital Market Association.

SHADOW BANKING RISKS

Three specific risks stand out in the Recommendations. First, that securities financing has a correlation with the build-up of leverage in the wider system. In this context, the Recommendations refer to the “procyclical” effect that the securities lending market can have in times of accelerating credit supply and asset price increases during periods of exuberance in markets. Procyclicality in this context broadly refers to prices, quantities or concentrations increasing as the overall economy is growing, and vice versa as the economy contracts, thus having the effect of exacerbating the prevailing economic trend. The concern is that securities financing may be procyclical due to the direct relationship of funding levels to fluctuating asset values (in other words, more can be “borrowed” against a strong asset value) and (via the level of haircuts) volatility. The Recommendations seek to restrict, or put a floor on the cost of, securities borrowing against assets subject to procyclical variation in valuations/ volatility, and in so doing reduce the potential for excessive leverage to build up in times of market stress. Second, that following a counterparty default, secured parties selling collateral securities in a “fire sale” manner will cause the value of those securities to fall, prompting further fire sales as other parties respond to the price fall, and so on. Third, that systemic risk is increased by the fact that financial institutions reliant on short term funding could fail due to liquidity shortages.

TRANSPARENCY

Consistent with the data reporting requirements under the European Market Infrastructure Regulation (EMIR) (as well as its US counterpart, the Dodd- Frank Act) with respect to derivatives, the Recommendations seem to be laying the groundwork for a system of greater transparency in the securities lending and repo markets. In fact, greater transparency forms one of the main themes of the Recommendations, which state that “Authorities should collect more granular data on securities lending and repo exposures ... with high urgency”.

In addition, trade level data and regular snapshots of outstanding balances should be collected by authorities, including through the use of existing data that resides in clearing agents, central securities depositaries or central counterparties (CCPs). The data should be provided to the FSB on a monthly basis, to enable the FSB to analyse the data and, where necessary, take appropriate steps to control activity. The FSB is expected to set standards and processes for data collection and aggregation to ensure consistent global data collection by relevant authorities and to minimise double-counting. REGULATION The proposals recommend a minimum level of regulation to apply globally, especially in relation to liquidity. For example, cash collateral in the hands of a securities lender (which may have been utilised by the lender) may be withdrawn by the borrower at any time, and the securities lender should ensure that sufficient cash or liquid assets are available to satisfy any such recall. In a similar vein, a securities lender should reinvest cash collateral in a prudent fashion. In other words, cash collateral should be invested in a suitably conservative way, with capital preservation as a high priority, taking into account that the securities lender may at any time be required to redeliver cash collateral to the borrower, and avoiding maturity mismatches which might cause problems. The proposals recommend that specific requirements are laid down, including, for example, that a minimum proportion of the cash collateral is kept in short term deposits or highly liquid short term assets. Furthermore, regulatory regimes applicable to non-bank entities should be put in place with appropriate minimum standards for cash collateral reinvestment to limit liquidity risk. Finally, the proposals also refer to regulation governing rehypothecation of client assets although it is not immediately clear what this is seeking to achieve, seeing as assets are delivered by way of title transfer in both repo and securities lending transactions and not by way of security (whereby ownership would stay with the client).

CENTRAL CLEARING

The Recommendations consider a central clearing system (whereby the CCP sits in between the parties to the trade and becomes the "central counterparty" to the two original counterparties) for repo and securities lending transactions. Central clearing is perhaps better known in the futures market and, as a result of recent regulation (namely EMIR and the Dodd- Frank Act), markets for certain categories of OTC derivatives. As the nexus of all trades, a CCP provides visibility to regulators as well as credit intermediation for all market participants. In addition to the advantages to having a reputable and robust central counterparty, a key reason for encouraging central clearing for repo and securities lending transactions is that the CCP can serve as a collector of data as well as a hub of funding activity for many forms of liquid collateral, thereby bringing this part of the "shadow banking system" into full view. It is unlikely that mandatory rules will appear for central clearing of repos because widespread clearing of repos and securities lending transactions is arguably not a realistic goal due to the nature of the transactions (as compared with, for example, futures). However, the FSB indicates that the establishment and wider use of CCPs for inter-dealer repos is to be encouraged for financial stability purposes, and regulators are urged to evaluate on an individual basis the appropriateness of a central clearing system applicable to securities lending and repos.

MINIMUM HAIRCUTS TO CONTROL LEVERAGE

Leverage can be built up, for example, through a party entering into a repo or securities lending transaction to obtain cash, then buying more securities with that cash, entering into another transaction, obtaining more cash, and so on. The idea behind setting minimum haircuts is to put controls on the build-up of leverage in a procyclical environment. Haircuts refer to the notional reduction in the value of securities when used to collateralise obligations under a transaction. So, in a securities lending transaction, the lower the haircut, the greater the amount of cash (and hence leverage) may be available under the transaction. The imposition of minimum (meaning higher) haircuts would therefore have the effect of limiting the value of securities for collateral purposes and thus limiting the amount of cash which may be obtained against such securities. Market participants are likely to press for minimum haircuts to apply only to transactions which finance nonbank entities, rather than to all market participants. Such an approach, whilst complicating matters somewhat, should have an effect consistent with the broad objectives in the Recommendations.

CONCLUSION

The FSB is to undertake further work to refine the Recommendations, including concentrating on proposed standards and processes for data collection and aggregation at the global level to ensure consistent data collection by national and regional authorities. Whilst reporting and data collection (and the resulting transparency) is entirely consistent with other global regulatory initiatives since the financial crisis of 2008, and is sure to have a very material impact on how regulators understand and can seek to control activity in this part of the shadow banking system, it would not be surprising if we see some watering-down of certain of the other proposals, considering the vital commercial role these markets play in providing liquidity.