

Regulation Watch

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Economic Analysis

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European Commission's proposal

on reporting and transparency of securities financing transactions

On 29 January, the European Commission (EC) released a proposal on new measures to address the risk of activity shifting into the shadow banking sector as a consequence of structural regulation. The measures aim to increase transparency in three main areas, covering some previous recommendations of the Financial Stability Board (FSB): (i) securities financing transactions (SFTs); (ii) investment funds (IFs); and (iii) rehypothecation. The approval of this regulation will be an important step, being the first regulation kit with an EU-wide scope (on shadow banking).

Main issues

- **This proposal has been presented as a complement to the proposed regulation on the structural reform of EU banks.** The aim is to **increase transparency** of securities lending and repo transactions and to enhance **market participants' understanding** of the risks involved. According to the EC's Green Paper (2012), **shadow banking** entities are involved in at least one of the following **activities**: (i) accepting funding with deposit-like characteristics; (ii) performing maturity and/or liquidity transformation; (iii) undergoing credit risk transfer; and (iv) using direct or indirect financial leverage.
- **Increasing transparency will help market players** to avoid unknown risks or those ones that are difficult to evaluate. The measures for increasing transparency in the EC's proposal are aligned with the **FSB's policy recommendations** of August 2013. To increase transparency **on the use of the SFTs by non-regulated entities** is the goal of the Commission's text, providing regulators, investors and counterparties a clearer view of the leverage the non-regulated entities incur, the maturity mismatch in their balance sheet and the liquidity risk they may face. **Banking entities** make an extensive use of SFTs; however, these entities **are not the main target** of this proposal as their SFTs are limited by the **CRR requirements** on capital, liquidity and disclosure.
- The **main points of the EC's text** are: (i) **Monitoring of the build-up of the systemic risk** generated by the SFTs in the European Financial system (reporting systems). (ii) **Disclosure** of such information to investors whose assets are employed in those transactions; (the fund managers must communicate relevant information periodically). (iii) **Contractual transparency** of rehypothecation activity (express actions to allow rehypothecation of collateral).
- **Timetable:** the legislative process is expected to be completed by end-2015: The first read by the **Council's** national experts is expected by **2Q14**, with amendments tabled in **Parliament** by **4Q14/1Q15** and a **potential political agreement** by **4Q15**.

Assessment

- **Positive:** BBVA **strongly supports** the proposed measures of **increasing market transparency** in shadow banking. Fostering transparency would **help regulators, investors and counterparties** to a better understanding of the risks they take. This proposal would **enhance consumer protection** as it ensures that concerned market actors have an appropriate understanding of the markets' functioning and the magnitude and nature of any associated risks.
- **Negative:** The proposal does **not mention** the **potential technical problems** that might arise as a consequence of its implementation. However, this issue was already analyzed by the FSB as far as the OTC derivatives reform implementation in September 2013. Therefore, it may be worth considering the **linkages with the derivatives reporting**, as analogous technical problems might emerge.

The Proposal

1. Scope

- **Which entities will be affected?**
 - **A counterparty of an SFT established in:** (i) **the EU** - including all its branches regardless of where they are located; (ii) **a third country outside the EU** - if the SFT is completed within the course of operations of an EU branch.
 - **Management companies of undertakings for collective investment in transferable securities (UCITS) and UCITS investment companies.**
 - **Managers of alternative investment funds (AIFMs).**
 - **A counterparty engaging in rehypothecation established in:**
 - a. **The EU** - including all its branches regardless of where they are located.
 - b. **In a third country outside the EU** in any of these circumstances: (i) the rehypothecation is executed in the course of the operations of an EU branch; (ii) the rehypothecation concerns financial instruments provided as collateral by a counterparty established in the EU or an EU branch of a counterparty established in a third country.
- **Which entities will NOT be affected**
 - **European System of Central Banks and other Member States bodies** performing similar functions and **other EU public-sector bodies** - charged with or intervening in the management of the public debt.
 - **The Bank for International Settlements (BIS).**
- **Main measures for increasing transparency:**
 - **In SFTs:** (i) SFT counterparties will have to report the details of the transactions to a trade repository (TR) registered with ESMA; (ii) the information will be centralised in the trade repository, directly and easily accessible to the relevant authorities¹, such as ESMA, the ESRB and the European System of Central Banks (ESCB).
 - **In IFs:** (i) fund managers will have to include detailed information about SFTs and similar financing structures in addition to the existing periodical reports; (ii) the fund's investment policy regarding SFTs and other financing structures will be clearly disclosed in pre-contractual documents.
 - **In rehypothecation:** (i) the counterparty receiving collateral will only be allowed to rehypothecate with the express knowledge of the risks and the consent of the providing counterparty, (ii) the recipient counterparty will have to transfer the received collateral to its own account.

2. Key definitions

- **Trade Repository (TR):** the proposal defines it as a legal person that centrally collects and maintains the records of SFTs.
- **Counterparties:** the proposal considers three different categories: (i) financial counterparties; (ii) non-financial counterparties; and (iii) CCPs.
- **SFTs:** The European Commission includes in the definition of SFTs: (i) repurchase transactions (repos); (ii) securities or commodities lending and securities or commodities borrowing; (iii) any transaction having an equivalent economic effect² and posing similar risks, in particular a buy-sell back or sell-back transaction.

1: This reporting scheme is aligned with EMIR transaction reporting.

2: i.e. total return swaps, liquidity swaps and collateral swaps. It might be overlapping with the EMIR reporting regime.

- **Rehypothecation:** this is the use by a receiving counterparty of financial instruments received as collateral in its own name and for its own account or for the account of another counterparty.

3. Securities Financing Transactions (SFTs)

- **Reporting obligation and safeguarding:** SFT counterparties shall report the details of the transactions to a trade repository according to the following patterns:
 - The details shall be reported **no later than the working day** following the conclusion, modification or termination of the transaction.
 - Counterparties shall keep a record for at least ten years following the termination of the transaction.
 - If a trade repository is not available to record the details, counterparties shall ensure that those details are reported to ESMA.
 - A trade repository shall regularly publish aggregate positions by type of SFT.
 - Delegation of reporting is allowed - as in EMIR.
 - The reported data can also be available to regulators in non-EU jurisdictions³.
- **Minimum information to be reported** for the different types of SFTs: (i) The parties to the SFT⁴; (ii) the principal amount; (iii) the currency; (iv) the type of SFT; (v) the quality and the value of the collateral; (vi) the methodology used to provide collateral; (vii) the availability of collateral for rehypothecation; (viii) if the collateral has been rehypothecated; (ix) if there has been any substitution of the collateral; (x) the repurchase rate or the lending fee; (xi) the counterparty; (xii) the haircut; (xiii) the value date; (xiv) the maturity date; and (xv) the first callable date.

4. Investment funds (IFs)

- **Transparency in periodical reports:** management companies of UCITS⁵, UCITS investment companies and AIFMs shall inform their investors on **the use** they make of SFTs as well as of other financing structures. They shall include this information as part of their half-yearly and annual reports.
- **Transparency in pre-investment documents:** The UCITS prospectus and the disclosure by AIFMs shall **specify** the **SFTs and other financing structures** they are authorised to use.

5. Rehypothecation

- **Rehypothecation of financial instruments received as collateral⁶:**
 - **Counterparties shall have the right to rehypothecation** where **at least all** the following conditions are met:
 - The providing counterparty has been duly informed in writing of the risks that may be involved in granting consent, in particular the potential risks in the **event of the default of the receiving counterparty**;
 - The providing counterparty has granted its **prior express consent** to a written agreement or an equivalent alternative mechanism.
 - **Counterparties that exercise their right to rehypothecation** will have to transfer the financial instruments received as collateral to an account opened in its name.

3: Through cooperation agreements with the EC.

4: Where different, the beneficiary of the rights and obligations arising from it.

5: Undertakings for Collective Investment in Transferable Securities.

6: A significant retroactive effect can take place if the exemption of existing rehypothecation contracts is not considered.

6. Administrative sanctions and measures

- **Competent authorities will have the power** to impose administrative sanctions and other administrative measures in relation to **at least** the breach of: (i) the reporting obligation and safeguarding in respect of SFTs; and (ii) the requirements for rehypothecation of financial instruments received as collateral.

7. Timetable

- The **legislative process** is expected to be completed by **end-2015**:
 - The first read-through by the **Council's** national experts is expected by **2Q14**,
 - The tabling of Parliamentary amendments by **4Q14/1Q15**; and
 - A possible **political agreement** by could be achieved by **4Q15**.
- The **regulation will come into force** 20 days after being published in the EU Official Journal:
 - **The restrictions on rehypothecation** will come into immediate effect
 - **IF disclosures** 6 months after the regulation comes into force; and
 - **SFTs will have to report to trade repositories** 18 months after the regulation comes into force.

8. Assessment:

- **Positive:** BBVA **strongly supports** the proposed measures of **increasing market transparency** in shadow banking. Fostering transparency would **help regulators, investors and counterparties** to a better understanding of the risks they take. This proposal would **enhance consumer protection** as it ensures that concerned market actors have an appropriate understanding of the markets' functioning and the magnitude and nature of any associated risks. The inclusion in the EC's text of some **operational requirements** to less regulated transactions similar to those imposed to derivatives transactions will help achieving a better knowledge of the markets a whole. Even if **securities lending and repo transactions** play an important role in liquidity generation, they also allow for a **high leverage** in the financial system which can lead to an **increase in market procyclicality**. In this vein, increasing disclosure and collecting more granular data is a necessary condition to better control financial vulnerabilities and ultimately reducing the fragility of the financial system.
- **Negative:** The proposal does **not mention** the **potential technical problems** that might arise as a consequence of its implementation. However, this issue was already analyzed by the FSB as far as the OTC derivatives reform implementation in September 2013. Therefore, it may be worth considering the **linkages with the derivatives reporting**, as analogous technical problems might emerge.

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