FÉDÉRATION BANCAIRE FRANÇAISE

FSB's CONSULTATION ON "*POSSIBLE MEASURES OF NON-CASH COLLATERAL RE-USE*"

FBF's ANSWER

The French Banking Federation ("FBF") welcomes the opportunity to respond to the FSB consultation on possible measures of non-cash collateral re-use. We highlight in our response our concerns about the FSB's suggestion that non-cash collateral re-use within the context of securities financing transactions ("SFTs") should be measured and tracked. In our opinion, this request is not justified at least within jurisdictions (such as EU countries) where the transparency of SFTs is already put in place.

FBF considers that this suggestion is not justified and may entail substantial side effects. The FBF's position is based on the following reasons, most of which are similar to these highlighted by the International Capital Market Association ("ICMA"):

1. **Measuring and tracking of collateral (and its re-use) cannot be completed in practice**

This practical impossibility is linked to the two following reasons:

a) **The multiple sources of transactions giving rise to collateral and the fungible nature of collateral securities having the same ISIN code**

Financial entities have a wide range of sources and uses of securities including investment transactions, market-making, trading, financing transactions, asset management, liquidity management or (initial and variation) margining. Consequently, financial entities receive collateral through a wide range of transactions and securities will be flowing in and out, with multiple daily transactions in any given line of securities (i.e. having the same ISIN code).

Transactions' recording enables financial entities to determine at any time the aggregate amount and number of securities of any given ISIN code, and consequently through which means collateral is received.

Nevertheless, all the securities having the same ISIN code (i.e. that form part of the same securities' issuance) are fungible and therefore cannot be distinguished. Financial entities will handle the securities within the "pool" of "usable" collateral as fungible, which implies that the tracking of the source of the collateral (and its re-use, if any) is purely theoretical and even impossible.

b) **The impossibility for financial entities to have a complete overview on the "chain" of re-use**

This impossibility is a consequence of:

- the fungible nature of the collateral securities having the same ISIN code (see here above);

- SFTs carried out within the EU are mainly based on "*title transfer collateral arrangement*s", which create bilateral links and relationships between counterparties and not a single interlinked chain. Consequently, while counterparties are able to determine the collateral received (or obtained) directly from their own counterparty, they do not have any overview on the origin of this collateral, especially if this collateral has already been used (and re-used) alongside previous transactions entered into.

2. The FSB's analysis is biased as it is linked to the US mechanism of "re-hypothecation"

As indicated above, most EU SFTs are based on *title transfer collateral arrangements*. Under this legal and operational mechanism, the receiving counterparty (collateral-taker) becomes the owner of the collateral and can dispose of the collateral at any time thereafter. The collateral-taker's right of "re-use" is not a right granted by the giving counterparty (the collateral-giver) but is actually a right of "use" linked to the fact that the collateral becomes the fully owned property of the collateral-taker.

On the contrary, US SFTs are based on re-hypothecation (or re-pledging) mechanism[1]. Pursuant to this mechanism, the collateral remains the own property of the collateral-giver. The collateral-giver granting a right of re-hypothecation to the collateral-taker retains the ownership until the collateral-taker exercises his right. Then, title to the collateral is transferred to the third party to whom the collateral has been re-hypothecated and the collateral-giver is contractually entitled to the return of fungible collateral.

The FSB therefore based its own consultation on a legal and operational mechanism used mainly in the US and not in the EU. The monitoring of collateral re-use may be justified in the former case (re-hypothecation). On the contrary, the transfer of ownership of the collateral to the collateral-taker pursuant to the EU scheme entitles the collateral-taker to use this collateral as its own property and there is no reason to "track" this "use" of collateral.

3. The collateral (and its potential re-use) do not raise any systemic risk and are even crucial for the financial markets

a) The collateral re-use does not raise any systemic risk

Because EU SFTs are mainly based on *title transfer collateral arrangements* creating bilateral links between counterparties and not a single interlinked chain (as indicated above), a default will only create a liquidation requirement for the direct impacted counterparty whereas all other transactions entered into through the chain of re-use will remain valid and enforceable. As a consequence thereof, the risk of interconnected collateral liquidations does not exist.

Of course, the counterparty faced with a default must be able to act clearly and decisively to liquidate his collateral and close-out his risk. That is why efficient SFTs' legal agreements need to be put in place, supported by legal opinions (to be regularly updated) acknowledging the reduction of the credit risk by collateral. This is the case, both in France and all over the EU.

[1] This mechanism is usually used by prime-brokers involved in the collateralisation of derivative transactions entered into with hedge funds.

b) The collateral re-use – linked notably to SFTs - is crucial for the financial markets

FBF wishes to highlight that collateral fluidity is crucial to ensure the efficiency of financial markets:

- SFTs (which include a substantial collateral use and re-use) play a central role within the financial system, notably with regard to (a) secondary and primary capital markets, where corporate and government borrowers raise money to finance their long-term needs (on the contrary, a badly functioning repo market would increase the cost of borrowing in the capital markets for corporates and governments) and to (b) the shorter-term money markets, which is crucial for the efficient liquidity management and collateral requirements ;

- In order to preserve an efficient functioning of the financial system, the collateral "*fluidity*" (which implies that the right amount, of the right type, of collateral is available whenever and wherever needed to meet the varying demand requirements) is crucial. This "*fluidity*" itself represents a purpose to achieve, which is not guaranteed on a permanent basis. Indeed, a high-quality collateral represents a scarce resource to be handled as such ;

- Consequently, FBF considers that an efficient use (and re-use) of the available collateral must be ensured. This implies:

  - On the firms' side, an appreciation of their sources and uses of the collateral and an identification of the best way to manage this collateral. This is a very complex challenge since the financial market system is subject to increasing regulation and the liquidity in financial markets decreases

  - On the regulators' side, an analysis of the impact of any potential new regulation on the collateral movement which may impact negatively the collateral fluidity. FBF recalls that collateral re-use is positive as it can help achieving the collateral fluidity. In case measuring collateral re-use should lead to any limitations on re-use, the impact on collateral fluidity would be negative and this situation would be detrimental to (a) the smooth functioning of the financial markets and, consequently, to (b) market participants, i.e. corporates, governments and investors (increasing costs, increasing risks , decreasing liquidity). This situation, if any, would even be detrimental to the efficiency of other regulatory measures put in place or contemplated to improve the financial system's stability.

4. <u>The collateral re-use is already controlled and regulated through different means</u>

The collateral re-use is already controlled and limited through different means, notably both market and prudential regulation:

- The <u>market regulation</u>: EMIR sets-up provisions aimed at increasing the safety and transparency of OTC derivative markets. Notably, it creates a legal obligation to clear certain types of OTC derivatives through central counterparties and, for those OTC derivatives exempted from clearing requirements, it creates a requirement to exchange (initial and variation) margins. This margin rules requirement (provided for in the Level 1 text dated 2012 and specified in a Level 2 regulation to enter into force on September 2016 with a phase-in period[2]) represents one of the various risk-mitigation techniques called by the authorities to reduce counterparty risk and to mitigate the potential systemic risk than can arise. Insofar, EMIR already provides for a specific control of the collateral use (and re-use, if any) ;

[2] These contemplated rules include notably risk-management procedures for the timely, accurate and appropriately segregated exchange of collateral (margin calculation, eligibility and treatment of collateral, operational procedures).

- The prudential regulation: its aim is to control directly the risk that an entity buys securities using its own funds and "repoes out" these securities to raise more funds with a view to using such funds to buy other securities (and so on) – which would breach credit limits and regulatory constraints. Insofar, FBF considers that there is no need to further focus on collateral re-use:

    - *Leverage ratio requirement*: the leverage exposure (denomination) is calculated with the gross SFTs assets recognised for accounting purposes (i.e. with no recognition of accounting netting) adjusted as follows: cash payables and cash receivables in SFTs with the same counterparty may be measured net if some strict criteria are met. In other words, the non-cash collateral (securities) cannot reduce the leverage exposure. The purpose of this rule is to prevent directly any potential excessive leverage ;

    - *Capital requirements*: the increase of the balance sheet of a financial entity increases the capital requirements imposed on such entity, which is costly and therefore restricts the capacity of such entities to post more collateral than is already owned or received. Besides, additional capital buffers are imposed on systemic important banks (G-SIBs) ;

    - *Liquidity requirements*: pursuant to the contemplated "*net stable funding ratio*" (to be put in place in 2018), initial margins posted by a financial entity will have to be funded (for at least 85 % of their amount) via stable resources having at least a 1-year-maturity, preventing thus financial entities to fund initial margins posted with initial margins received.

- In reference to UCITS funds and ETF specifically, the recent ESMA Guidelines on ETF and UCITS Issues (https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf) published on 1 April 2016 stipulate in point 43 (j) that [non-cash collateral received should **not** be sold, re-invested, or pledged].

5. The FSB's consultation does not take into account the content and rationale of the existing EU regulation

The FSB's consultation does not take into account that the transparency of SFTs is already put in place by the European regulation. Indeed, pursuant to the recent EU Regulation "*on transparency of SFTs and of re-use*"[3] ("SFT Regulation"), new rules have been set-up to increase the transparency SFTs and to assist supervisors and investors in better understanding the risks related to such transactions:

- The SFT Regulation imposes on SFTs counterparties to report the details of SFTs entered into to trade repositories registered with ESMA. This rule will enable supervisory authorities to be informed of any SFTs entered into (and consequently to monitor any concentration risk if any);

- The SFT Regulation imposes specific constraints on the re-use of the collateral received. Notably, the right of counterparties to re-use financial instruments received as collateral shall be subject to specific conditions, i.e. (a) a prior express consent by the collateral-giver to a security collateral arrangement providing a right of re-use, and (b) the information of the collateral-giver by the collateral-taker of the risks and consequences linked to the consent to a right of re-use. Consequently, any collateral being re-used in a subsequent SFT will form part of the reported information (to trade repositories, and indirectly to supervisory authorities), as that subsequent SFT will itself have to be reported.

[3] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015.

For all these reasons, FBF considers that concerns over interconnectedness and potential systemic risk should be monitored on the periodic reporting of positions between the (major) banks, broken down by types of collateral – and not through the tracking of individual collateral re-uses as this individual tracking will not enable regulators to have an appropriate overview of the global and systemic risk linked to such collateral re-use.

Question 1: **Does the proposed scope of transactions for data collection (Scope A) provide a practical basis for the meaningful measure of non-cash collateral re-use? If not, please explain how you think the scope should be broadened and the reasons why this alternative scope is more appropriate than the proposed scope.**

FBF agrees with the FSB's recommendation that the scope of the data collection on re-use should be limited to SFTs (i.e. Scope A) for the following reasons:

- limiting the scope of data collection to SFTs is appropriate since the FSB's focus in on assessing global trends and risks in relation to SFTs;

- non-cash collateral re-use in other type of products such as OTC derivatives may be more limited due to the prevalence of cash collateral and/or segregated non-cash collateral;

- FSB's proposed scope of re-use measure (Scope A) will consequently represent the most relevant data to assess overall global trends in collateral re-use.