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Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel, Switzerland

Re: Comment on consultative document "Possible Measures of Non-Cash Collateral Re-Use" (dated: 23 February 2016)

INTRODUCTION

I am grateful for the opportunity to comment on the consultative document "Possible Measures of Non-Cash Collateral Re-Use" published by the Financial Stability Board (FSB) on 23 February 2016 (hereinafter, the "Document").

The FSB's initiative is warmly welcome. Today, there is very little data on collateral re-use in securities financing markets being collected by national authorities and the proposed measures will enlighten our understanding of the potential systemic risks arising from collateral re-use. Nevertheless, the potential of these proposed measures to improve our understanding of collateral re-use could be further strengthened with the following recommendations:

- The proposed scope of transactions for data collection could be expanded to capture the full extent to which collateral is re-used in securities financing transactions. In re-defining that scope, the FSB should take into account similar data collection initiatives in other markets (mainly, non-centrally cleared derivatives).
- In addition to the data elements set out in Table 1 of the Document, the FSB should consider requiring covered entities to report:
    - the specific financial collateral arrangement used to document SFTs;
    - the possible restrictions on the collateral taker's right to re-use;
    - the "Total collateral received";
    - the specific counterparty with which collateral is re-used;
    - the purpose for which a collateral taker has re-used received collateral.
- The FSB should consider the possibility of committing to treat sensitive data on a confidential basis.
- The FSB should consider the express request that national authorities submit Table 4 in the Document to the FSB.

A more elaborate description of these recommendations is provided in the next Section.

DETAILED COMMENTS

Q1. 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.

Proposed scopes will only provide an incomplete picture of collateral re-use

Scope A features two clear restrictions: covered entities will only have to report data on collateral re-use when a) they post it or receive it under a securities financing transaction (SFT) and b) re-use it in another SFT.[1] In light of the scope of the FSB's mandate, the first restriction is reasonable and desirable from a practical perspective: in principle, the FSB is not required to monitor risk in *all* financial markets where collateral might be re-used. However, the second restriction can be more problematic for the FSB as it will provide an incomplete measure of collateral re-use in SFTs. For example, it will not capture those SFTs where collateral is re-used for purposes other than collateralising another SFT, e.g. collateralising a derivatives transaction. Moreover, it will not capture those SFTs where the collateral received thereunder is the result of one of the parties re-using collateral previously received under a non-SFT (e.g. a derivatives transaction) unless that collateral is *subsequently* re-used in another SFT.[2]

Scope A and B are defined as if they were tangent, i.e. one ends where the other begins; in other words: the combination of the two would give us a full picture of the extent to which collateral is re-used in the financial system. For that statement to be true, Scope B would have to encompass all the situations that the second restriction leaves out of Scope A, which include certain SFTs. To return to the geometry analogy: to get a full picture of collateral re-use, Scopes A and B would actually have to be secant, i.e. there will have to be some overlap between them. As I will explain below, this will require an important degree of co-operation at the international level.[3] But more importantly: if international bodies responsible for collecting information on collateral re-use in other markets (e.g. non-centrally cleared derivatives markets) adopt an equally narrow scope such as the proposed Scope A to monitor collateral re-use in those markets, there will be no data on how collateral re-use can interconnect different markets. These interconnections can lead collateral chains to act as channels of contagion spreading shocks across different markets.[4]

Without transgressing the boundaries of the FSB's monitoring mission over SFTs, the proposed Scope A could be broadened by reporting, not only whether collateral posted

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[1] Specifically, the FSB notes that: 'In line with the scope of the global securities financing data standards, the scope is restricted to collateral posted or received and *subsequently* re-used in SFTs.' Financial Stability Board, 'Transforming Shadow Banking into Resilient Market-Based Finance. Possible Measures on Non-Cash Collateral Re-Use' (2016) 3. (Emphasis added.)

[2] In other words: if the collateral received under a derivatives transaction is re-used to be posted as collateral under a SFT and then it is no longer re-used, then this SFT will not fall under Scope A.

[3] See the sub-section "International co-ordination" in this Comment to Q1.

[4] For a more elaborate description, see Comment to Q10.

or received is subsequently re-used in SFTs, but also whether: a) any such collateral posted or received has been received under another transaction and re-used to collateralise the relevant SFT; b) any collateral posted or received under a SFT is then subsequently re-used in transactions other than SFTs. In relation to this latter element, covered entities may report general references (e.g. the general type of transaction where the collateral assets have been re-used) or specific references (e.g. name of the counterparty with which collateral has been re-used, as well as the specific type of contract where the collateral has been re-used). The latter option would be preferable.[5]

International co-ordination

When discussing Scope B, the Document notes that such a broader approach 'may prove more complex and costly for entities involved, requiring a longer time to implement the reporting of additional data items.'[6] While it is true that participants in non-centrally cleared derivatives markets, for example, do not currently have any obligation to report data on their collateral re-use practices, recent international standards suggest that such reporting obligations may be required in the near future.[7] If national regulators developed reporting standards that used, where possible, similar metrics to those proposed by the FSB, then broadening Scope A as suggested in the previous paragraph would not necessarily result that much more complex and costly for entities involved. It would if these entities were required to report very different metrics to different supervisors.

The FSB's working in close cooperation with national regulators seeking to adopt reporting rules on collateral re-use in non-centrally cleared derivatives would have an additional advantage beyond minimising reporting costs for the covered entities: it would improve the comparability and aggregation of data across different markets. As argued above, narrowly defined scopes of reporting will probably not be tangent, i.e. the aggregation of the information reported under each reporting scope will not provide a full picture of collateral re-use; in particular, such aggregation will probably miss those transactions where collateral is received in one market and re-used in another. Being able to identify and quantify these interconnections between different markets through collateral chains can help supervisors understand potential contagion effects. Unless there is one international body collecting data on collateral re-use in different markets from regulators in different jurisdictions, the scopes of transactions for data collection of the different international bodies will necessarily have to be secant, i.e. there will have to be some overlap between them. Otherwise, international bodies risk having a collection of patches instead of a full picture.

[5] See Comment to Q7 below.

[6] Financial Stability Board (n 1) 3.

[7] For example, in March 2015, the BCBS and IOSCO published their final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives. This policy framework urges national regulators to put in place data collection frameworks that will allow them to monitor any risk arising from the level and volume of collateral re-use. See Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, 'Margin Requirements for Non-Centrally Cleared Derivatives' (2015) 22.

Q4. Are there other measures of collateral re-use that the FSB should consider for financial stability purposes?

In relation to the comment to Q1, I would suggest that the data item representing the market value of collateral re-used of asset type *j* by entity *i* should also be reported in the following two cases: (a) by any entity *i* that receives asset type *j* as collateral under a SFT and re-uses it in any transaction (be it a SFT or otherwise); and (b) by any entity *i* that re-uses asset type *j* received as collateral under another transaction (be it a SFT or otherwise) to post it under a SFT transaction.[8]

Q5. Do you have views on any of the six metrics related to collateral re-use that are set out in this Section? If so, please indicate the metric(s) and explain the views you have.

Section 4 of the Document states that the proposed metrics 'could allow for a more in-depth assessment (than is possible using currently available data) of several market characteristics that have been linked to financial stability risks (e.g. interconnectedness, degree of concentration).' While these metrics would improve the ability of national authorities and of the FSB to evaluate the stability risks mentioned, some of those risks, like those arising from interconnection, might require the FSB to broaden the scope of data collection,[9] to request national authorities to collect more granular detail from individual institutions,[10] and to co-operate closely with national authorities collecting data on collateral re-use in other markets (particularly derivatives markets).[11]

Q7. In your view, are the data elements set out in Table 1 appropriate for calculating the collateral re-use measures in Section 3? Are there alternative data elements that the FSB should consider? If so, please explain the data elements and the reasons.

The data elements that the FSB proposes in Section 5 of the Document are aggregates. In general, the FSB should consider requiring national authorities to collect and submit to the FSB more granular data on collateral re-use, e.g. that each covered institution reports data on each of the transactions under which it has posted or received collateral. More specifically, the FSB should consider the following issues.

Firstly, in order to further clarify the eligibility of collateral re-use, the FSB should consider introducing a data element about the type of financial collateral arrangement under which the reporting institution has posted or received collateral. Some financial collateral arrangements used in securities financing markets give the parties the possibility to restrict (or even prohibit) the ability of the collateral taker to re-use

[8] This last criterion would allow Scope A to cover transactions such as those described in note 2 above.

[9] See Comment to Q1 above.

[10] See Comment to Q7 below in relation to the identification of the specific counterparties of a reporting institution.

[11] See Comment to Q1 above.

received collateral.[12] In this sense, the FSB should also consider requiring reporting institutions to specify the particular type of collateral that may not be eligible for re-use. The availability of data about the specific financial collateral arrangement used to document SFTs and the possible restrictions on the collateral taker's right to re-use would provide national authorities and the FSB with a better understanding of the eligibility of posted or received collateral to be re-used.

Secondly, the FSB should consider including a data element for covered entities to report the total market value of collateral received. At the moment, Table 1 only includes "Total collateral posted". Coupled with the data element "Total collateral received, eligible for re-use", a data element showing "Total collateral received" would allow national authorities and the FSB to calculate a ratio of how much collateral received is eligible for re-use. Moreover, coupled with the data element "Collateral re-used", a data element showing "Total collateral received" would allow national authorities and the FSB to calculate a ratio of how much received collateral was actually re-used. These ratios would give national authorities and the FSB an idea of what proportion of received collateral participants could potentially re-use. These are common ratios in other markets.[13]

Thirdly, the FSB should consider monitoring the individual interconnections of covered entities arising from collateral re-use. In Section 5 of the Document, the FSB notes that '[w]here feasible, these data elements should be broken down by asset type of the collateral as well as type and location of the counterparty.' The granularity of these details is very welcome. Most of the metrics described in Section 4 of the document were aggregate metrics. While those metrics can be illustrative of general practices in collateral re-use in different jurisdictions, they will not provide national authorities and the FSB with information about how different market participants might be exposed to each other by means of collateral re-use. In other words: those metrics do not provide granular details about the interconnections of each individual institution.

Although identifying the type of location of the counterparty, as specified above, would improve the understanding of national authorities and the FSB of such interconnections, ideally, the identification of the counterparties of each of the reporting institutions should be specific (i.e. the exact name of the counterparty), rather than a general reference to the "type" of counterparty. Only by collecting data about the individual counterparties of a reporting entity will national authorities and the FSB be able to assess possible systemic risks in connection with collateral re-use. For example, this information would allow them to monitor the risk of collateral providers recalling collateral from a particular institution and exposing the latter to potentially destabilising liquidity pressure.[14] They would also be able to monitor the impact of the failure of a large participant on its counterparties and on the stability of securities financing

[12] For example, Section 4.1 of the Master Securities Loan Agreement (MSLA), prepared by the Securities Industry and Financial Markets Association (SIFMA), allows the securities Lender (i.e. the collateral taker) to "Retransfer" (i.e. re-use) received collateral (including non-cash collateral) only if Lender is a Broker-Dealer. For a definition of the scope of the right to Retransfer (i.e. re-use), see Section 25 of the MSLA. All terms in capital letters must be read in conjunction with the definitions provided under the MSLA. For a list of such definitions, see Section of 25 of the MSLA.

[13] See e.g. International Swaps and Derivatives Association, 'ISDA Margin Survey 2015' (2015) 13–14.

[14] For a more elaborate description, see Comment to Q9.

markets. Ideally, such granular detail would further allow regulators to discriminate between risks that would threaten to disrupt systemic stability and others that would not, and to better adapt their policy responses to the crisis situation.

Finally, the FSB should consider introducing a data element that would reflect the purpose for which a collateral taker has re-used received collateral by requiring reporting institutions to provide a general reference (e.g. the general type of transaction where the collateral assets have been re-used) or a specific reference (e.g. name of the counterparty with which collateral has been re-used, as well as the specific type of contract where the collateral has been re-used).[15] Once again, a more specific reference would allow national authorities and the FSB to map out the individual interconnections of market participants arising from "collateral chains".[16] Additionally, if both collateral providers and collateral takers are asked to report data on collateral re-use, specific references of the counterparties from (to) which collateral is received (posted) would allow national authorities and the FSB to cross-check the reported data.

A reporting institution need not provide information about all collateral that is posted, received and re-used under every individual transaction with each of their counterparties. For each counterparty, the reporting institution could provide information about collateral being posted, received and re-used under a master agreement that might group several different SFTs with the same counterparty.[17]

Q8. Are there any practical issues on the data elements for calculating the collateral re- use measures that are set out in Table 1?

If any of the data elements described in the previous comment or specified in Table 1 is considered to be highly sensitive, the FSB should specify that such data will be reported to national authorities, and later submitted to the FSB, on a confidential basis. In particular, data elements about the name of specific counterparties and amounts of collateral received under specific transactions may be regarded as particularly sensitive.

Q9. In your view, should the collateral types for measuring collateral re-use align with those set out in the November 2015 global securities financing data standards as set out in Table 1? If not, please explain which collateral types you think are appropriate for the collateral re-use measure(s).

Yes. The FSB should also try to make collateral types for measuring collateral re-use align with collateral types specified in the regulatory framework for haircuts on non-

[15] See also Comment to Q1 above.

[16] The re-use of an asset received as collateral creates a succession of contractual rights over the same collateral asset collateral. This succession of contractual rights is often described as a "collateral chain".

[17] When two parties have entered into more than one SFT they often group all those SFTs under a master agreement and calculate the amount of collateral to be posted and received on a net basis, i.e. as if there was only one obligation to post collateral. See e.g. International Capital Market Association and Securities Industry and Financial Markets Association, 'Global Master Repurchase Agreement' (2011) s 4.

centrally cleared SFTs.[18] Such compatibility would allow national authorities and the FSB to monitor the degree of over-collateralisation in SFTs and to assess the potential risks arising from the re-use of collateral when the collateral taker is over-collateralised.

One such risk is that collateral providers run away from their collateral takers exposing them to considerable liquidity pressure and nearing them to the brink of insolvency. When the collateral provider decides to grant the collateral taker a right to re-use collateral it is effectively waiving its proprietary rights over the collateral. In the event of the collateral taker's default, the collateral provider will only have a contractual claim against the collateral taker for the return of equivalent collateral.[19] Alternatively, the collateral provider could decide to terminate all outstanding transactions and to calculate the close-out amount.[20] If the collateral taker is over-collateralised,[21] the collateral provider will only have a contractual claim for the over-collateralised amount. In both cases, the collateral provider's contractual claims are unsecured. Typically, unsecured creditors are only able to satisfy a meagre part of their claims, if anything at all.[22]

When the collateral taker is over-collateralised (e.g. it has taken a very high haircut on securities collateral), has re-used the securities collateral, and is nearing insolvency, collateral providers would have an incentive to "run" from the collateral taker by reducing their exposures to the collateral taker in order to avoid their unsecured claim being caught in an insolvency proceeding. The liquidity pressure resulting from such behaviour could push the collateral taker over the brink of insolvency.

Q10. Are there any views on the data architecture issues related to measuring collateral re-use as set out in this Section? Do you see any statistical issues arising as a result of the proposed aggregation approach?

Table 4 (i.e. aggregation of collateral re-use by type of collateral) would be particularly useful for supervisors to assess the potential vulnerability of different market participants to fluctuations in the market value of collateral assets. For example, if the market value of collateral type 1 were to drop, all market participants (i.e. collateral providers) having posted collateral type 1 could be potentially exposed to margin calls from their collateral takers. It is important to note that, when collateral type 1 has been

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[18] See Financial Stability Board, 'Transforming Shadow Banking into Resilient Market-Based Finance. Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions' (2015).

[19] Supposing the collateral provider had complied with its own obligation under the contract. Otherwise, it could decide to terminate all outstanding transactions and to calculate the close-out amount, i.e. the sole amount payable by either party after netting all the outstanding amounts between them.

[20] See e.g. International Capital Market Association and Securities Industry and Financial Markets Association (n 17) 10(b), 11(2)(b).

[21] The collateral taker will be over-collateralised if it holds collateral the value of which is greater than the collateral taker's exposure under the SFT, e.g. if it has taken a very high haircut on securities collateral.

[22] Gerard McCormack analysed some data from the end of the 1990s provided by the Society of Practitioners of Insolvency. He concluded that 'on average 75 per cent of cases return nothing to unsecured creditors and in only 2 per cent of cases can they expect to receive 100 per cent returns.' Gerard McCormack, *Secured Credit under English and American Law* (Cambridge University Press 2004) 7.

re-used, every collateral taker that has re-used that collateral will also be a collateral provider to the subsequent collateral taker. This duality emphasizes the importance of margin calls being met in an orderly manner to avoid collective deleveraging problems.

For margin calls to be met in an orderly manner four conditions must be met: (1) that all collateral takers make a margin call on their respective collateral providers; (2) that they are made for the same type of collateral asset; (3) that they are made for the same amount; and (4) that any given margin call is not due before any of the margin calls on precedent collateral providers (i.e. that the first collateral provider in the chain is the first link along the chain to meet its margin call, so that the second collateral provider – first collateral taker– can re-use the collateral received under the margin call it made to meet the margin call it faces from the second collateral taker, and so on). Because different contracts include different valuation dates, methods, and margin call procedures, the longer the collateral chain (i.e. the greater the number of contracts under which the same collateral asset has been re-used), the more difficult it will be for the four conditions described above to be met and, as a result, the more difficult it will be for margin calls to be met in an orderly manner.

Moreover, the more a specific type of collateral asset is re-used (either under the same collateral chain or under different ones), the greater the number of market participants that will be exposed to that specific type of collateral asset. If margin calls are not met in an orderly manner (i.e. they cannot rely on their collateral providers posting collateral that they could then re-use to meet the margin calls they themselves face), different links along the collateral chain might have to either meet their margin calls by posting their own assets, or by liquidating some of their own assets. As a result, a collective reaction to margin calls following the drop in the market value of that specific type of collateral asset could have an impact on the prices of other assets, transforming collateral chains into channels of contagion.

By quantifying the exposure of every reporting entity to each collateral type, Table 4 could allow supervisors to identify the risks arising from those margin calls not being met in an orderly manner. Therefore, the FSB should consider an express requirement for national authorities to collect the necessary data to compile Table 4 and to report such Table to the FSB. In addition, because the same collateral asset may be re-used with participants in different jurisdictions, the FSB should aggregate the total collateral received, posted and re-used for each collateral type at the global level to have an idea of which jurisdictions concentrate the market participants with the greatest exposure to one particular asset type. This aggregated information would provide the FSB with the necessary information to evaluate the potential impact of collateral chains as channels of contagion.

CONCLUSION

I would like to reiterate my gratitude for the opportunity to comment on the proposed measures. I hope that you will find these comments useful. I remain at your disposal to further clarify any comments that might attract your attention. You will find my contact details on the first page of this letter.

Yours sincerely,

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