



February 12, 2015

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002 Basel, Switzerland  
FSB@bis.org

Re: "Additional data for financial stability purposes," per the FSB Consultative Document: Standards and Processes for Global Securities Financing Data Collection and Aggregation (November 13, 2014)

Dear Sirs and Mesdames:

We are writing to urge the inclusion of a limited set of underlying activity metrics for securities lending in the global securities financing data initiative ("Initiative"). As described, the Initiative is intended to outline the design of a monitoring system to help market supervisors infer changes in systemic risk that are said to be created by securities lenders, repo traders and margin lenders. However, we believe that global aggregates which are limited to position metrics will have minimal value, and may well prove to be misleading.

Position aggregates in securities lending may help track the level of cash collateralized loans. But position aggregates alone cannot track the risk of collateral fire sales, one of the main systemic risks that supervisors have linked to securities finance. Fire sales result when borrowers return or lenders recall a significant proportion of their positions. Aggregates may show the position changes, but cannot help to anticipate changes in the underlying dynamics affecting the risk of fire sales.

It seems clear to us that, if the risk of collateral fire sales is to be fairly calibrated, loan recalls and returns must be tracked along with position aggregates. Still, lending agents can mitigate these termination risks with rebate incentives, cash buffers and loan substitutions, as described below. Therefore, to achieve their policy objectives, we believe that Financial Stability Board and national and regional authorities must expand the data initiative beyond position aggregates, to include risk mitigation resources as well as termination activity. Aircraft pilots cannot monitor risks based solely on altitude; neither can market supervisors.

#### About the Center

The mandate of the Center for the Study of Financial Market Evolution ("CSFME"), which was founded in 2007 as a not-for-profit research firm, is to assist academics and supervisors in evaluating market practices and structures. The CSFME's first

major project was a study of alleged proxy vote manipulation by hedge funds through the U.S. securities lending markets. A major finding of the 2010 report was that incomplete data had misled researchers into assuming that activity spikes on proxy record dates were due to hedge fund borrows, when the spikes were actually lender recalls and agents' loan substitutions.<sup>1</sup> Our recommendations to expand the Initiative are based partly on the lessons of this study, and partly on the experiences of the CSFME's founder in creating the first securities loan pricing and benchmarking systems.<sup>2</sup>

### FSB Policy Goals

The Initiative is based upon the FSB Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, published on August 29, 2013 ("Policy Framework"). We understand the goals of the Initiative, as mandated in the Policy Framework, to be the creation of supervisory metrics to:

1. "subject cash collateral reinvestment to regulatory limits on liquidity and leverage risks."
2. "restrict, or put a floor on the cost of, securities 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."
3. "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."
4. "reduce (i) the risk of financial contagion and (ii) opacity."
5. "improve collateral valuation practices."

### Discussion

Our recommendation to collect termination and mitigation metrics is intended to address Policy Goal #4, specifically the risk of financial contagion.

The Policy Framework defines financed positions as "amount of security lent." The Initiative proposes an expanded data definition, but the data element tables in the consultation document are still designed to capture only aggregate positions. With position values, supervisors would (at best) only be capable of interpreting changes to market *leverage*. Even if this view can be achieved, we question the utility of leverage alone as a risk metric for an activity as dynamic as global securities finance.

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<sup>1</sup> The CSFME empty voting white paper is available on the SEC's website, at: <https://www.sec.gov/comments/s7-14-10/s71410-202.pdf>.

<sup>2</sup> As CEO of ASTEC Consulting, Ed Blount created a securities lending database of 90,000 global issues, which he sold to SunGard Data Systems in 2007.

Supervisors should also consider the possibility that activity spikes, capital withdrawals and similar sources of position turmoil in the underlying transaction markets can intensify *liquidity* risk and, in turn, heighten systemic exposure to fire sales in collateral pools. To monitor this risk, the data tables should be expanded to include aggregates for loan terminations such as recalls, returns and collateral redemptions. Loan originations might also be included to monitor linked financing activity from agency substitutions of recalled loans and on-lending activity.

Finally, and most significantly, we strongly recommend that the Initiative include data elements that can help to monitor the role of financial intermediaries who act as systemic risk mitigators. Market stability can be supported if agent banks, prime brokers and central counterparties retain the capability and willingness to absorb or deflect the stresses caused by loan terminations on the collateral of securities lenders and financed positions of margin customers.

### Loan Terminations

It is the rapid and uncontrolled unwinding of securities finance positions, not the accumulation of those positions, that intensifies systemic risk. Market supervisors have spoken time and again of the threat to market stability from widespread recalls and returns of securities loans, as those terminations can lead to forced redemptions of cash collateral and the untimely sale of pool investments.<sup>3</sup>

Despite the risk of unwinding, the consultation for the Initiative makes no reference to data that can be used to calibrate the potential for sudden termination of posi-

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<sup>3</sup> In "Unwinding of Securities Lending Transactions" (Section 3 of the 2009 Senior Supervisors Report on *Risk Management Lessons from the Global Banking Crisis of 2008*), there are several instances of the adverse effects of loan terminations cited, with emphasis added:

A number of U.S. cash collateral reinvestment funds experienced ... pressures as some borrowers redeemed cash collateral and some lenders curtailed lending or withdrew (or attempted to withdraw) cash collateral. (p.10)

Major credit disruptions ... triggered an unwinding of securities lending transactions. Securities lenders retreated across the major markets, reducing exposures by recalling securities on loan, severely curtailing new loans, and reducing the tenors of new transactions. (p.11)

The liquidity stress was greatest in the United States, owing to its larger emphasis on cash collateralized transactions... Agent lenders faced a huge demand to return securities to the beneficial owners and cash collateral to borrowers, along with a high number of margin calls. The funds thus experienced shortages of cash associated ... with the return of securities from deleveraging hedge funds ... (pp. 11-12)

Operationally, the pullback by the beneficial owners contributed substantially to the spike in "fails" (the failure of trades to settle) in September 2008. The number of beneficial owners (including many foreign central banks) calling their securities back for fear of dealing with any broker-dealers reduced the supply of Treasury securities available to make settlement. (p.12)

tions. Indeed, the terms “recall,” “returns,” and “redemptions” do not even appear in the consultation document.

Ultimately, the absence of termination metrics will make it difficult, if not impossible to understand changes in the stability of financed positions. Consider a situation in which 10,000 positions are terminated in a particular month, while 15,000 are added. As proposed, the data framework will report only the net gain of 5,000 positions. If, in a subsequent month, a reported gain of 5,000 positions is the result of far greater activity, e.g., 100,000 terminations vs 105,000 originations, the inherent potential for market disturbance will be missed under the currently proposed framework. Even more significantly, it will also be impossible to monitor the degree to which financing intermediaries have sufficient resources to mitigate the risk of uncontrolled terminations, as discussed below.

### Rebate Incentives

We question whether it will be possible to monitor, much less form a quantitative basis for policy decisions that restrict the true cost of securities finance, as cited in Policy Goal #2 above, through reference to aggregate fee and rebate metrics alone. Pricing in securities finance is highly sensitive to availability and demand for the security being financed, as well as collateral quality, counterparty relationships, trade size, position stability, market volatility, yield curves, spread dynamics, and a host of other factors. All of these will be overlooked in aggregates and the cost of carry, a major influence on position finance, will be distorted by a simple average.

Nevertheless, certain pricing metrics can be useful for monitoring the ways in which agent banks manage their cash pools and prime brokers control their cage operations. For example, agent banks can use rebates to maintain the stability of their cash collateral pools. In 4Q2008, during a period of falling short-term rates, agent banks raised rebate rates as an incentive to borrowers considering the removal of their cash collateral after the Lehman failure. This is one way in which agent banks protected the stability of their reinvestment pools during the temporary period of stress caused by the liquidity crisis.

If pricing metrics are included for new and terminated loans, it may be possible to monitor the direction of incentives as a complementary data point for related trend analytics. Aggregate pricing will have little value for such purposes.

### Intermediaries as Risk Mitigators

In addition to rebate incentives, both agent banks and prime brokers have procedures and systems for reducing the degree to which the termination of financed positions will lead to in buy-ins and forced sales. Agent banks in receipt of a customer recall notice will often substitute shares available from other customers to avoid

closing out the loaned position. In this way, the agent banks avoid passing the recall along to the borrowing prime broker. Similarly, those prime brokers who have received a recall notice can tap other sources of supply, either internal or external, then return those shares to avoid forcing a buy-in on a customer's short position.

In the case of returned loans, agents who maintain uninvested cash or a cash-equivalent buffer in their collateral pools can meet redemption demands from borrowers without selling collateral. As a rule, cash managers for securities lending programs maintain a significant part, often 10% to 20%, in the "core liquidity" of their collateral reinvestment portfolios. Like mutual fund managers, cash managers for securities lenders vary the proportion in response to changing market conditions and counterparty behavior, thereby influencing the lenders' yield in order to manage the redemption risks.<sup>4</sup>

In addition to the risk mitigation capacity of banks and brokers, the proposed inclusion of central counterparties to the securities finance markets may offer the possibility of further buffering and substitution capabilities. Indeed, it may also be possible to enhance the industry's ability to mitigate systemic risk if CCPs are able to provide capital efficiencies to intermediaries through their operations.

The consultation document for the Initiative does not include metrics for calibrating the degree to which banks, brokers or central counterparties can ameliorate the effects of sudden terminations of financed positions. At a minimum, it would seem necessary to consider the relative size of cash buffers, as well as available and lendable, but unloaned securities positions, as compared with relative termination activity and newly originated and existing on-loan positions. However, to be accurate, cash buffering should be tracked on a portfolio basis for agents who manage more than one collateral pool, and the substitution metrics should be tracked at least on an asset class or sector basis, if not an issue-by-issue basis, to avoid distortion.

With the inclusion of flow data aggregates, particularly recalled and returned loan termination metrics, it should be possible for national and regional authorities to monitor the degree to which intermediaries are providing an effective systemic risk mediation service. Furthermore, global aggregates with greater granularity will allow authorities to derive more accurate comparisons when evaluating the risk profiles of regulated market participants, especially those with extensive cross-border counterparties, holdings and transaction activity.

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<sup>4</sup> "According to JP Morgan," as cited in a BlackRock white paper, "current cash cushions across the industry average 4% for equity, 9% for bond and 12% for hybrid or balanced mutual funds, which invest globally in a combination of equities, bonds and cash and cash equivalents." Available at <https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf>

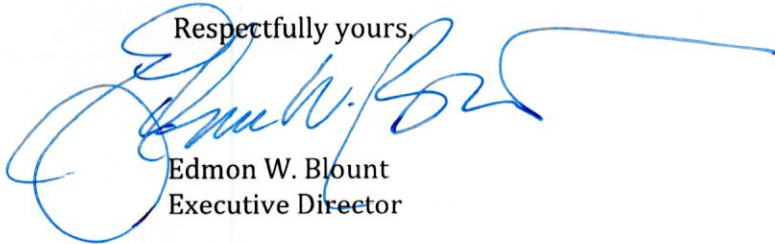
Submission of Supplemental Comments

Private entities and trade groups have already collected many of the data flow elements in previous analytic exercises. Notably, in the 2010 study of empty voting, cited above, the CSFME created and relied on a five-year, U.S. securities finance activity database of more than one billion loan transaction records. However, to our knowledge, the loan substitution, cash buffering and other risk mitigation activities of securities finance intermediaries have never been analyzed. It is entirely possible that intermediaries themselves do not track or retain the appropriate metrics in their systems, since they may never have had the need to justify their contributions to systemic risk mitigation.

Consequently, we plan to consult with securities finance intermediaries and present a more detailed description of their activities and reporting capabilities, then submit a supplemental response to the Initiative consultation within 60 days of this initial commentary. We also plan to consult with academic research teams in order to assess the possibility of providing interim metrics for consideration by the FSB's Data Experts Group. We hope to provide the results of the academic assessment at the same time frame as our supplemental submission of comments.

Thank you for the opportunity to participate in the Initiative consultation. If our current comments and intended supplements appear to be useful to FSB staff, we welcome inquiries and suggestions in order to further refine our research goals and methods.

Respectfully yours,



Edmon W. Blount  
Executive Director