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BBVA's response to the FSB's proposed regulatory framework for haircuts on non-centrally-cleared securities financing transactions

BBVA welcomes the opportunity to comment on the Financial Stability Board's (FSB) proposal for a regulatory framework for haircuts on non-centrally-cleared securities financing transactions.

BBVA congratulates the efforts that the FSB is taking in developing policies to strengthen the oversight and regulation of the part of the financial system that extends credit but is outside the regular banking sector, the so-called "shadow banking system". These efforts are essential to prevent the proliferation of non-regulated structures that evade the new financial sector regulatory framework established to reduce systemic risk, the procyclicality of the financial markets and the use of taxpayers' money to rescue financial institutions.

The FSB correctly identifies securities financing transactions as activities that may be used to generate leverage and that may give rise to maturity transformation. The whole new financial regulatory framework should correctly assess the risks generated by this type of transactions and set the appropriate measures to prevent the build-up of excessive risks.

Securities financing transactions are fundamental for the functioning of the financial markets; they are necessary for performing market-making activities, for implementing central bank's monetary policy and for day-to-day funding of financial and non-financial entities. A regulatory initiative focused on this type of transactions should be simple and should carefully avoid creating unnecessary burdens, duplicities and wrong incentives to the regulated financial sector.

BBVA agrees with the FSB's proposed regulatory framework for haircut on non-centrally cleared securities financing transaction intention to limit the build-up of excessive leverage outside the banking system, and also to reduce the procyclicality of this leverage. BBVA also considers appropriate the use of two complementary elements to determine minimum haircuts; an analytical methodology and a simpler numerical haircut floor. However, BBVA believes that the application of the minimum qualitative standards for methodologies to determine minimum haircuts to all market participants' financing transactions goes beyond the stated intention of the framework.

Regulated financial entities are already subject to regulation on capital and liquidity which play an important role in preventing the build-up of excessive leverage and maturity transformation within the regulated financial world. The application of the minimum standards, proposed in the framework, may duplicate requirements and put unnecessary additional burdens to regulated entities. For example, the Basel Prudential Regulation Framework already takes into account securities finance transactions in the two capital ratios banking entities will have to comply with; the risk weighted assets capital ratio and the leverage ratio (the Basel Committee on Banking Supervision has even recently proposed a review of the leverage ratio that would significantly increase the impact of securities finance transactions on this ratio). In addition, this framework includes two liquidity ratios that restrict maturity transformation; (i) A Liquidity Coverage Ratio (LCR) that requires banking entities to hold an amount of high quality liquid assets (HQLA) large enough to cover potential outflows over a period of 30 days of stressed funding markets, (ii) a Net Stable Funding Ratio (NSFR) that requires items requiring stable funding to be covered by items providing stable funding.

In addition, security financing transactions are key instruments through which entities raise liquidity from their stock of securities. Basel III LCR will force banking entities to accumulate a stock of high quality liquid assets (HQLA) to serve as liquidity backstop in case of a temporary freeze in the financial markets. A high minimum haircut on securities included in the eligible pool for HQLAs may diminish the liquidity of these securities and may exclude some of them from the pool of eligible HQLA, making more difficult for banks to comply with this requirement. Furthermore, the minimum haircuts under this framework may be higher than the haircuts to be applied to the HQLAs for the calculation of the LCR. Therefore, methodology determining the haircut for this purpose should be fully aligned with the one used for liquidity ratios calculation.

Finally, monetary policies are conducted through open market operations in which, in normal circumstances, banking entities receive financing from central banks by posting assets as collateral. In these operations, the central bank should be able to freely determine the haircut to apply to each type of security they choose to accept as collateral; otherwise this framework may impose a severe limit on the flexibility of central banks in the implementation of their monetary policy.

Furthermore, the minimum standard haircuts under this framework should be coordinated with the haircuts established by central banks in their open market operations; should the minimum standard haircuts be higher than the ones determined by the central banks, some unintended consequences may arise:

- Incentives for the banking system to raise funding from central banks, rather than accessing other market participants, increasing the dependence of entities to central banks' liquidity.
- Incentives for the banking system to post to central banks assets for which the difference between the minimum standard haircut and the central bank haircut is larger. This is an arbitrage opportunity banking entities would exploit giving rise to risk concentration on central banks' balance sheets.
- Market distortions; securities in which a large difference occur between the minimum haircut stemming from this framework and the haircut established by a central bank, will tend to be allocated on the balance sheet of the banking entities with direct access to funding from this central bank.

To prevent duplicities, unnecessary burdens, wrong incentives, unfair advantages and market distortions, BBVA suggests that **for transactions in which a regulated financial entity receives financing, the minimum standard haircuts under this framework should not be higher than the haircuts the central banks establish to apply on their main monetary policy operations, in case collateral is represented by assets included in the eligible pool of the central bank of the monetary area in which the regulated entity is established.** An adjustment to the minimum standard haircuts, when the maturity of the securities financing transaction deviates from the maturity of the central bank main monetary policy operation, will have to be taken in consideration.

BBVA considers that the minimum standards for methodologies described in Section 2 and Section 3 of the FSB's consultation paper take into account most of the important historical factors that should be taken into account in setting the risk-based haircuts. However, we believe that the methodology proposed may bear an intrinsic weakness; the methodology focuses only on past stressed scenarios and does not take in consideration potential new stress scenarios the securities may incur into. Financial history has shown that past experience is quite often not a good guide for the future; new stressed environments may affect assets in a way that may depart significantly from the way it was affected in past stressed periods.

With respect to numerical floors, BBVA suggest to extend the application of the numerical haircut floors to all transactions through which a non-regulated entity receives funding, notwithstanding the nature of the lender. Otherwise, arbitrage opportunities may arise that would undermine this framework effectiveness in limiting the risk of excessive leverage and maturity transformation in shadow banking entities,

To conclude, BBVA believes that FSB's efforts to strengthen the oversight and regulation of the shadow banking system are fundamental in the global regulatory reform of the financial system, and that the proposed framework on haircuts in non-centrally cleared securities finance transactions will be an essential tool in the prevention of excessive leverage and to avoid the risks generated by maturity transformation in the shadow banking system. However, BBVA considers that the proposed framework goes beyond FSB's stated intention by proposing to apply the minimum standard methodology to all market participants' securities financing transactions; it may generate unnecessary additional burdens for entities already subject to regulation on capital and liquidity that prevents them from excessive leverage and maturity transformation. Additionally, wrong incentives may be created on banking entities access to funding from central banks through market securities financing transactions, when definitions of monetary policy operations haircuts and minimum standard haircuts under this framework are not coordinated. To prevent such consequences, BBVA suggests including a cap on the minimum haircut that would apply on securities financing transactions through which a regulated entity receives funding by posting an asset included in the pool of eligible assets for monetary policy operations established by the central bank of the monetary area in which the regulated entity is located. In these transactions, the minimum haircut should not exceed the monetary policy operations haircut (adjusted for differences in the maturity of the transactions).