FSB FINANCIAL STABILITY BOARD

Press release

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FSB Publishes Interim Report on Securities Lending and Repos

The Financial Stability Board (FSB) published today a report entitled *Securities Lending and Repos: Market Overview and Financial Stability Issues*. The report describes the segments, operations and practices of these securities financing markets, which may constitute an important element of the shadow banking system. The FSB is examining the regulation of securities financing markets from a financial stability perspective as part of its wider work on shadow banking, on which the FSB will issue recommendations by the end of 2012.

The report released today is an Interim Report of the FSB Workstream on Securities Lending and Repos and is preliminary to its work to develop policy recommendations in this area. The Workstream has reviewed current market practices through discussions with market participants, and classified the markets into four main, inter-linked segments:

(i) a *securities lending segment* which comprises lending of securities by institutional investors to banks and broker-dealers against the collateral of cash or securities;

(ii) a *leveraged investment fund financing and securities borrowing segment* which comprises financing of leveraged investment funds' long positions by banks and broker-dealers using both reverse repo and margin lending secured against assets held with the prime broker, as well as securities lending to hedge funds by prime brokers to cover short positions;

(iii) an *inter-dealer repo segment* which comprises primarily government bond repo transactions amongst banks and broker-dealers that are typically cleared by central counterparties (CCPs); and

(iv) a *repo financing segment* which comprises repo transactions primarily by banks and broker-dealers to borrow cash from "cash-rich" entities, including central banks, retail banks, money market funds, securities lenders and increasingly non-financial corporations.

The Workstream identified five key drivers that have contributed to the growth of these markets: (i) demand by risk-averse institutions for "money-like" instruments to support their primary investment objectives of preserving principal and liquidity; (ii) the financing needs of financial intermediaries such as banks and broker-dealers; (iii) growth of investment strategies that use leverage and involve short selling; (iv) increased need for banks and broker-dealers to gain access to securities for the purpose of optimising the collateralisation of repos, securities loans and derivatives (the so-called "collateral mining"); and (v) securities lenders and their agents seeking to enhance investment returns.

The Workstream views the following aspects of securities financing markets as constituting potentially important elements of the shadow banking system, as defined by the FSB:

- *repo financing by non-bank entities* to create short-term, money-like liabilities, typically collateralised by longer-term securities;
- *leveraged investment fund financing* that may lead to further leverage and maturity transformation;
- *securities lending cash collateral reinvestment* by which the cash proceeds from short sales are used to collateralise securities borrowing and then reinvested by securities lenders into longer-term assets, thus constituting a long credit intermediation chain with maturity transformation; and
- *collateral swaps* (also known as collateral downgrade/upgrade transactions) that can further lengthen transaction chains or allow banks to meet liquidity requirements.

In addition to mapping securities financing markets and clarifying their locations within the shadow banking system, the Workstream reviewed existing regulatory frameworks through a survey of regulatory authorities.

From its review of market practices and regulatory frameworks, the Workstream has preliminarily identified seven issues arising from the securities financing markets that might pose risks to financial stability and/or need further investigation by the Workstream:

(i) *lack of transparency* – securities financing markets are complex, rapidly evolving and can be opaque for some market participants and policymakers;

(ii) *procyclicality of system leverage and interconnectedness* – securities financing markets can influence the leverage, complexity and level of risk-taking within the financial system in a procyclical and potentially destabilising way;

(iii) *other potential financial stability issues associated with collateral re-use* – collateral re-use can reinforce procyclicality, and may have other potentially destabilising effects on the financial system;

(iv) *potential risks arising from fire-sale of collateral assets* – non-defaulting counterparties can be expected to sell collateral securities immediately following a default in order to realise cash or buy back lent securities, triggering collateral "fire sales";

(v) *potential risks arising from agent lender practices* – agent lenders' practices in handling customer assets and in offering indemnities to their customers against the risk of borrower default need further investigation;

(vi) *securities lending cash collateral reinvestment* – by reinvesting cash collateral received from securities lending transactions, securities lenders (including non-banks) can effectively perform "bank-like" activities that involve maturity/liquidity transformation and leverage; and

(vii) *insufficient rigour in collateral valuation and management practices* – inappropriate collateral valuation and management practices may create vulnerabilities, as seen during the early stage of financial crisis.

These financial stability issues will form the basis for the next stage of the Workstream's work, which is to develop appropriate policy measures to address risks, where necessary, by the end of 2012.

The FSB welcomes comments on this report, in particular on the issues arising from the securities lending and repo markets that might pose risks to financial stability. Comments should be submitted by 25 May 2012 by email to fsb@bis.org or post (Secretariat of the Financial Stability Board, c/o Bank for International Settlements, CH-4002, Basel, Switzerland).

Notes to editors

At the Cannes Summit in November 2011, the G20 Leaders endorsed the FSB's report *Shadow Banking: Strengthening Oversight and Regulation* which sets out initial recommendations with a work plan to further develop them in the course of 2012. Five workstreams have been launched under the FSB to develop policy recommendations to mitigate potential systemic risks in the following areas: banks' interactions with shadow banking entities; money market funds; other shadow banking entities; securitisation; and securities lending and repos. The FSB submitted a *Progress Report* on these workstreams to the G20 Finance Ministers and Central Bank Governors in April 2012.

The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.

The FSB is chaired by Mark Carney, Governor of the Bank of Canada. Its Secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements. For further information on the FSB, visit the FSB website, www.financialstabilityboard.org.