European Commission - Fact Sheet

Regulation on transparency of securities financing transactions and of reuse: Frequently Asked Questions

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What is this Regulation about?

The proposal on the Securities Financing Transactions Regulation, which was adopted in January 2014 alongside the proposal for the structural reform of the EU banking sector (see IP/14/85 and MEMO/14/63), aims to improve the transparency of the securities financing markets. The proposal was announced as part of the action plan on shadow banking in September 2013 (IP/13/812). Political agreement was reached between the Parliament and Council on 17 June 2015 (IP/15/5210), and the European Parliament Economic and Monetary Affairs Committee (ECON) voted on the text on 16 July 2015. Following the European Parliament's vote, the Regulation will be formally adopted by the EU Council of Ministers in the near future. The Regulation will then be published in the Official Journal of the EU.

What are Securities Financing Transactions (SFTs)? What are they used for?

SFTs include a variety of secured transactions that have similar economic effects such as lending or borrowing securities and commodities, repurchase (repo) or reverse repurchase transactions (reverse repo) and buy-sell back or sell-buy back transactions,including collateral and liquidity swaps. The main SFTs are securities lending and repos.

Securities lending is primarily driven by market demand for specific securities and is used, for instance, for short selling or settlement purposes. In this type of transaction, the lending counterparty lends securities for a fee against a guarantee in the form of financial instruments or cash given by their clients or counterparties.

Repos/reverse repos are generally motivated by the need to borrow or lend cash in a secure way. This practice consists of selling/buying financial instruments against cash, while agreeing in advance to buy/sell back the financial instruments at a predetermined price on a specific future date.

What is shadow banking?

Shadow banking can be defined as a system of credit intermediation that involves entities and activities outside the regular banking system. Shadow banks are not regulated like banks, though their operations are often like those of banks, as they:

- Take in funds similar to deposits;
- Lend over long periods and take in deposits that are available immediately (known as maturity and/or liquidity transformation);
- Take on the risk of the borrower not being able to repay; and
- Use borrowed money, directly or indirectly, to buy other assets.

They may include entities such as securitisation vehicles or conduits, money market funds, investment funds that provide credit or are leveraged, such as certain hedge funds or private equity funds and financial entities that provide credit or credit guarantees, which are not regulated like banks or certain insurance or reinsurance undertakings that issue or guarantee credit products.

Shadow banking also includes activities, in particular securitisation, securities lending and repurchase transactions, which constitute an important source of finance for financial entities.

Shadow banking activities can be helpful since they ensure diversification of financing sources for the economy but needs to be subject to appropriate regulation and transparency requirements.

What are the main elements and benefits of the Regulation?

Transparency is important in understanding how the market works, what the risks are and what their magnitude is.

In this respect, transparency is important as it provides the information necessary to develop effective and efficient policy tools to prevent systemic risks.

The Regulation aims to improve the transparency of SFTs in the following three ways:

First, the Regulation requires transactions (except where one of the party is a central bank) to be reported to a central database. This will allow supervisors to better identify the links between banks and shadow banking entities. As a consequence, supervisors will be able to monitor the exposures to and risks associated with SFTs and, if necessary, take better-targeted and timelier actions.

Second, the Regulation will improve transparency towards investors on the practices of investment funds engaged in SFTs and total return swaps by requiring detailed reporting on these operations, both in the regular reports of funds and in pre-investment documents. The disclosures required by this Regulation will therefore not only enable regulators to access valuable information, but will also benefit investors, who will be able to take better-informed investment decisions.

Finally, this Regulation will improve the transparency of the reuse (any pre-default use of collateral by the collateral taker for their own purposes) of financial instruments by setting minimum conditions to be met by the parties involved, including written agreement and prior consent. This will ensure that clients or counterparties have to give their consent before reuse can take place and that they make that decision based on clear information on the risks that it might entail. The reuse by financial companies can create financial stability risks (for more on the risks of reuse, please refer to section further down).

Why is there a need to address shadow banking?

The shadow banking sector needs to be better monitored because of its size, its close links to the regulated financial sector and the systemic risks that it may pose. There is also a particular need to prevent the shadow banking system from being used for regulatory arbitrage.

In addition to the risks associated with circumventing the rules and the fact that these shadow banking entities/activities can lead to high levels of debt being built up in the financial sector, authorities should monitor this sector for two main reasons:

1. Size: The latest studies indicate that the aggregate shadow banking assets are about half the size of the regulated banking system. Despite the fact that shadow banking assets have decreased slightly since 2008, the global figure at the end of 2012 was €53 trillion[1]. In terms of geographical distribution, the biggest share is concentrated in the United States (around €19.3 trillion) and in Europe (Eurozone with €16.3 trillion and the United Kingdom with around €6.7 trillion).

2. Interconnectedness: Any weakness that is mismanaged or the destabilisation of an important factor in the shadow banking system could trigger contagion that would affect other sectors.

How is the Commission addressing the risks inherent to shadow banking?

The Commission has already implemented, or is in the process of implementing, a number of measures to provide a better framework for these risks, such as harmonised rules applying to AIFs[2] and reinforcing the relationship between banks and unregulated actors.[3]

In September 2013, the Commission adopted a Communication in which it set out its roadmap and its priorities in the shadow banking area[4] (IP/13/812). At the same time, the Commission adopted a proposal for a Regulation on Money Market Funds[5].

As indicated in the shadow banking communication, the Commission is taking a proportionate approach by focusing on activities and entities that pose a high level of systemic risk to the economic and financial sector. Increasing transparency and reducing risks associated with SFTs have been identified as two of the main priorities.

The Regulation on transparency of SFTs and of reuse addresses these two priorities. The establishment of reporting obligations to trade repositories, the new disclosure requirements for investments funds and reuse will enhance the transparency of securities financing markets. It will notably allow supervisors to access detailed, reliable and comprehensive data to monitor risks originating in shadow banking and to intervene when necessary.

Why now? Should the Commission not wait until the reform of the regulated financial sector is fully implemented?

The financial crisis highlighted the need to improve regulation and monitoring outside the regulated banking sector, because the volume of transactions carried out outside the core banking sector had increased tremendously and risks created could be systemic.

The Commission has been working on measures that respond to the risks identified in the past, but also ensure that new activities or techniques do not create systemic risk. The European Parliament also adopted an own initiative report on shadow banking in November 2012.

Why is additional regulation necessary in view of the ongoing extensive reform of the financial sector?

The Commission has undertaken the biggest ever reform of financial services regulation with the aim of restoring sustainable health and stability to the sector. The approach consists of tackling all financial risks and ensuring that the benefits achieved by strengthening certain actors and markets are not diminished by financial risks migrating to less regulated sectors. Therefore, it is necessary to strengthen regulation, including outside the regulated banking sector. In parallel, the Commission has recently launched a "call for evidence" to gather feedback and gauge the cumulative impact and interaction of current financial rules. The feedback to this consultation will provide a clearer understanding of the interaction of the individual rules and their cumulative impact towards fostering growth in the EU economy.

What preparatory work has been done before proposing this Regulation?

The preparation of this proposal has involved collecting information and views from a wide range of stakeholders over the past two years. In particular, it takes into account:

- The input received as part of the Commission consultation on the Green Paper on shadow banking and during a public conference as well as the policy conclusions set out in the Commission Communication on Shadow Banking;
- A public consultation in 2012 on various issues concerning UCITS (Undertakings for Collective Investment in Transferable Securities), including transparency requirements;
- The results and responses to a public consultation in 2012 by the Financial Stability Board on the problems identified in securities financing markets, including the lack of transparency;[6]
- The European Parliament's own initiative report on shadow banking which highlighted the importance of appropriate measures in this area;[7]
- Discussions with Member States' experts.

Is the Regulation consistent with the Financial Stability Board Recommendations?

Financial markets are global, hence systemic risks created by shadow banking entities and activities need to be tackled in an internationally coordinated manner. The Commission is therefore following very closely the work of the Financial Stability Board (FSB), which is in charge of identifying risks and developing recommendations to address those risks.

In August 2013, the FSB adopted 11 Recommendations to address the risks inherent to securities lending and repurchase agreements. The Regulation is in line with four of these Recommendations (Numbers 1, 2, 5 and 7) related to the transparency of the securities financing markets, disclosure to investors and rehypothecation (which is covered by the term 'reuse' as defined under the SFTR.

In this respect, this Regulation is an important step as it provides the necessary to policy tools in the areas already identified by the FSB.

The Regulation is consistent with the work of the FSB. In particular:

- It provides for highly granular and frequent reporting of SFTs to trade repositories (Recommendations 1 and 2).
- It provides for enhanced disclosure of the use of SFTs to fund investors (Recommendations 5).
- It provides for rules on rehypothecation improving the disclosure to clients and counterparties (Recommendation 7).

Elements of the Regulation specific to reporting to trade repositories

Who will be required to report SFTs to trade repositories?

Any EU financial or non-financial entity will be required to report. This includes banks, brokers, funds, insurance companies, pension funds, other financing companies and non-financial companies. Small and medium enterprises will not have to report their transactions with financial entities themselves: these transactions will be reported by their financial counterparty.

The European System of Central Banks, the Bank for International Settlements and public bodies managing public debt are exempted from reporting in order not to jeopardise their discretionary policies.

Who will have access to the data collected by trade repositories?

Supervisors and regulators responsible for financial stability and securities markets will have access to the data. These include the European Securities and Markets Authority (ESMA), the European System of Central Banks, the European Systemic Risk Board, the European Banking Authority, the European Insurance and Occupational Pensions Authority and the relevant national authorities.

How will this reporting work in practice?

The reporting of SFTs will be based on the existing reporting framework for derivative contracts established by the European Market Infrastructure Regulation (EMIR) and will work in a similar way i.e. a counterparty to a SFT will have to report the details of this transaction to a trade repository. ESMA will supervise this reporting framework and will develop specific technical standards on reporting procedures, access to data procedures and registration procedures for trade repositories.

Elements of the Regulation specific to reporting to fund investors

What kind of risks do SFTs and total return swaps create for fund investors?

SFTs and total return swaps are used by fund managers to earn additional returns or to secure additional funding. For example, repo transactions are often used to raise cash for additional investments. Total return swaps are used by fund managers to get exposure to certain strategies or to enhance the returns. At the same time, all these transactions create new risks, such as counterparty risk and liquidity risks that materialise if the counterparty to the transactions defaults. Generally, only a part of the additional earnings is attributed to the fund, but the entire counterparty risk is borne by the fund's investors. Therefore, the use of SFTs and total return swaps may alter the risk-reward profile of the fund.

How do the new disclosure requirements help investors?

The disclosure requirements will provide investors with all relevant data regarding the use of SFTs and total return swaps by the fund. The idea is not to overload investors with every detail on each transaction the manager performs, but to provide information on these transactions in a concise and aggregate manner. This will allow investors to understand the risks and returns directly linked to the use of such transactions. This will also enable investors to assess the level of risk of the (potential) fund investment and make it easier to compare between different fund investments. Furthermore, as managers will be obliged to disclose the information, they may have more incentive to act in the interests of investors.

Elements of the Regulation specific to reuse

What is reuse?

Reuse is mainly employed by financial companies (e.g. banks, dealers, brokers). It allows them to use for their own purposes financial instruments that have been given to them by their clients or counterparties as collateral, especially to borrow money in the wholesale markets. (Example: a hedge fund posts financial instruments as collateral with its prime broker, which then uses these instruments for its own transactions. The hedge fund is usually compensated for this by lower borrowing costs or fees).

What are the risks of reuse?

Reuse has several risks:

- When reuse takes place, the ownership of the financial instruments is replaced with a contractual claim to the return of equivalent financial instruments. In practice, this is akin to an unsecured obligation.
- Reuse allows for the same financial instruments to create multiple obligations that interconnect different actors within the market. These obligations amount to a multiple of the value of the reused financial instruments, creating concerns for financial stability because of amplified leverage and procyclicality.
- Reuse forms complex chains of transactions hidden from market participants and regulators. This increases the possibility of a run on a financial company if there are concerns about its creditworthiness.

The uncertainty surrounding the extent to which financial instruments have been reused can create financial stability risks. This would be especially relevant where clients or counterparties have insufficient visibility over the risks and the use of financial instruments.

What specific rules on reuse does this Regulation introduce?

The Regulation harmonises requirements on reuse in the EU. It sets out four conditions to be fulfilled:

1. The client or the counterparty needs to give its consent for its assets to be reused;

2. The entity wishing to engage in reuse should disclose the potential risks and consequences, for example those in the event of default;

3. There should be a prior written agreement;

4. The financial instruments should be transferred from the account of the client's or counterparty's own account (i.e. the reuse should not take place on the client's or counterparty's own account).

Stricter rules could be allowed at national level or in sectoral EU legislation.

What is the scope of the rules on reuse?

The rules will apply to all EU entities as well as to those third country entities that reuse financial instruments provided by an EU entity. The rules will cover any collateral arrangement under the Financial Collateral Directive i.e. title transfer collateral arrangement or security interest collateral arrangement.

For more information:

http://ec.europa.eu/internal_market/finances/shadow-banking/index_en.htm

[1] Global Shadow Banking Monitoring Report 2013, 14 November 2013, FSB.

[2] Alternative Investment Fund Managers Directive (AIFMD).

[3] For instance, the provisions related to securitisation exposures in the revised Capital Requirements Directives.

[4] http://ec.europa.eu/internal_market/finances/shadow-banking/index_en.htm

[5] http://ec.europa.eu/internal_market/investment/money-market-funds/index_en.htm

[6] A total of 49 responses were received from trade associations, intermediaries, asset managers, market infrastructures and public authorities.

[7] Cf. European Commission: Green Paper Shadow Banking, Brussels, 19.3.2012 and European Parliament: Report on Shadow Banking (2012/2115(INI)), A7-03654/2012, 25.10.2012.

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