Reporting and transparency of securities financing transactions

Securities financing transactions (SFTs) are a variety of secured transactions, which allow market participants to exchange assets temporarily, pledging them as guarantee for a funding transaction. They contribute significantly to the efficiency of financial markets, among others, by broadening and stabilising the money market, facilitating central bank operations, ensuring liquidity in the secondary debt market, contributing to more efficient settlement (through faster processing and failure prevention), and allowing more efficient employment of capital.

Types of transactions to be regulated

The Commission put forward a proposed regulation on 29 January 2014 aimed at a number of types of securities financing transactions, in particular securities lending and repurchase agreements ('repo'). **Securities lending** describes transactions involving a temporary transfer of the security's legal title from one party to another (which serves as collateral), in exchange for legal ownership of other securities or cash. A **repurchase agreement** is an agreement to sell an asset (usually a fixed-income security, such as a bond) and to buy it back again from the same counterparty on a later date at an agreed price. Although securities lending and repurchase agreements look similar, there are some fundamental differences between them, with regards to the *motivation for their use* (the need to borrow securities in the case of securities lending; the need to borrow cash in the case of repurchase agreements), the *underlying asset* (mainly equities in the case of securities lending; mainly fixed-income securities in the case of repurchase agreements) and, finally, with respect to the *right of recall* (the right for lenders to recover their securities if they wish, in order for instance to exercise voting rights), which is mainstream practice in the case of securities lending; but is not usually provided for in a repo transaction.

Other SFTs covered by the proposed regulation, include **buy-sell back** or **sell-buy back** transactions (similar to repurchase agreements, but with the principal difference that these transactions may or may not be documented, whereas a repurchase agreement is always evidenced by a written contract); **liquidity swaps** (securities exchange, in which a party will lend another a large portfolio of highly liquid bonds for a period of three to ten years, and secure them with a larger pool of collateral made up of less liquid assets); **collateral swaps** (securities exchange, where one party lends high quality assets to another – such as 'AAA' government bonds – and in return receives collateral to mitigate the risks); and **total return swaps** (securities exchange, in which one party makes payments based on a set fixed or variable rate, while the other party makes payments based on the return of an underlying asset, which includes both the income it generates and any capital gains), as laid down in Regulations (EU) No 575/2013 and (EU) No 231/2013.

Rationale for regulating

This proposed regulation complements a second proposed regulation on structural measures improving the resilience of EU credit institutions, which aims to enhance the financial stability in the European Union through structural reform of large banks. That proposal is still under discussion in the Economic and Monetary Affairs Committee (ECON) – rapporteur: Gunnar Hökmark, EPP, Sweden. The main axes of that proposal are the prohibition of proprietary trading; the obligation for relevant banks to submit a 'separation plan' to competent authorities; as well as the empowerment of supervisory authorities to review certain trading activities and to require the separation of some of them deemed to be high-risk activities. Banks, however, may attempt to circumvent the rules of that proposed regulation, by shifting parts of their activities to the less-regulated shadow banking sector (the system of credit intermediation involving entities

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PE 569.033

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– such as special purpose vehicles, money market funds and hedge funds – which operate outside the regular banking system) through the use of securities financing transactions. Given that both the Financial Stability Board and the European Systemic Risk Board have noted the lack of reliable and in-depth data on these transactions, which makes it difficult to monitor risk concentration and identify counterparty exposures, such a shift could create systemic risk and threaten the stability of the financial system. It was therefore decided to complement the proposed regulation on structural measures with another, which would aim to make securities financing transactions more transparent, to ensure that shadow banking activities involving them would be properly supervised and regulated.

Main points of the Commission proposal

The proposal aims to increase the transparency of securities financing transactions by:

- requiring all transactions to be reported to a trade repository, so as to give supervisory authorities the possibility to better monitor exposure to (and risks associated with) securities financing transactions and, if necessary, take targeted and timely action;
- requiring investment funds to provide detailed reporting on such operations, in both regular reports and pre-investment documents, to improve transparency towards actual and prospective fund investors;
- improving the transparency of the re-hypothecation (see box) of financial instruments, by setting minimum conditions to be met by the parties involved, including written agreement and prior consent.

Re-hypothecation (changed to 'reuse' in the compromise text) allows financial companies to pledge to a third party, for their own purposes (especially to borrow money in the wholesale markets), financial instruments that have been given to them by their clients or counterparties as collateral. Because it can amplify leverage and pro-cyclicality, as well as be used to form complex chains of transactions hidden from market participants and regulators, it is considered a source of risk to financial stability.

Main amendments to the text

The amendments introduced in the compromise text agreed in trilogue in June 2015, further to the April report of the ECON Committee (rapporteur: Renato Soru, S&D, Italy), focus on the following areas:

- the central banks of the European System of Central Banks are exempt from the obligation to report their SFTs to trade repositories but must cooperate with competent authorities, including by providing them directly with a (confidential) description of their SFTs, upon request;
- credit institutions and listed non-financial companies should disclose particular information about SFTs in their pre-contractual documents (prospectus), as well as their activities in SFTs in their half-yearly and annual reports, so as to allow prospective or actual shareholders to make informed choices about the risk profile of the companies in which they invest;
- the Commission's term 're-hypothecation' is replaced by the term 'reuse', to promote international consistency of terminology (it should be noted, however, that the term should not be confused with the same term employed in Directives 2009/65/EC and 2011/61/EU);
- the modalities of equivalence and recognition of trade repositories, indirect access to data between authorities and equivalence of reporting are further developed;
- amendments are introduced to Regulation EU 648/2012, in particular with regard to the definition of over-the-counter (OTC) derivatives and to equivalence decisions.
- Finally, under the new regulation, the Commission will have to report on:
  - the effectiveness, efficiency and proportionality of the obligations under the regulation;
  - progress in international efforts to mitigate the risks associated with SFTs, including on the FSB recommendations for haircuts on non-centrally cleared SFTs;
  - the application of Article 11, which regard to fees charged to trade repositories by the European Securities and Markets Authority (ESMA).

  In that context, ESMA will have to

  - identify material risks related to the use of SFTs by credit institutions and listed companies;
  - assess whether the use of SFTs leads to the build-up of significant leverage that is not addressed by existing regulation, the options available to tackle such a build-up, and whether further measures to reduce the pro-cyclicality of that leverage are required.

The compromise text needs now to be confirmed in a first-reading plenary vote, in the October III session.