



Securities Finance: Regulatory Update

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At our annual Securities Finance Regulatory Update, we discussed the current regulatory climate and the impact of regulation on securities finance.

The update was hosted by **Bill Kelly**, Global Head of Client Management & Business Development, Securities Finance, BNY Mellon. The speakers were **Mike McAuley**, Global Head of Product Strategy, Securities Finance, BNY Mellon and **Eli Peterson**, Managing Director, Office of Public Policy and Regulatory Affairs, BNY Mellon.

THE CURRENT REGULATORY CLIMATE

Regulators around the globe are focusing on systemic risk and financial stability across firms, products and services. In the past, regulators would review these firms, products and services individually, and regulations were aimed at preserving safety and soundness at a micro level. With today's more comprehensive approach, regulators are looking at the size, complexity and interconnectivity of firms, products and services and how together they can contribute to systemic risk.

To help preserve financial stability and mitigate systemic risk, regulators are introducing new requirements with two main objectives;

- preventing large global banks from failing, and if a bank does fail, muting the consequences of this fail and curtailing market dislocation
- increasing transparency

Regulators around the globe are pursuing these objectives, but it is not necessarily a coordinated effort.

When reviewing the new regulations, it is also important to consider the issue of parity among the different types of transactions. It could be argued that under recent regulations derivatives are receiving preferential treatment compared to securities financing transactions. This may largely reflect the regulators' strong focus on derivatives directly after the 2008 financial crisis.

Overall, the current regulatory climate is complex. Regulations are changing the securities finance marketplace and affecting the way borrowers, agent lenders and beneficial owners behave and interact. Understanding these changes is a difficult task but an important one.

A Review of Recent Regulations

US SUPPLEMENTARY LEVERAGE RATIO (SLR) – THE BORROWER’S BALANCE SHEET

The SLR is having a significant impact on securities finance. This measure is a ratio of an institution’s capital to its assets, and it is having the greatest effect on the borrowers in a securities lending transaction. As borrowers look to manage their balance sheet in line with SLR requirements, they are increasingly interested in posting non-cash collateral in securities lending transactions. In addition they have also reduced their level of participation in the repo market which impacts the ability to invest cash collateral.

The SLR is also driving conversations around the development of a buy-side friendly model for the central clearing of agency securities lending and repo transactions. A CCP clearing model would allow borrowers some benefits of accounting netting (i.e., offsetting cash payables with cash receivables) which potentially permits them to engage in a higher volume of transactions without negatively impacting their balance sheet. This could become another distribution channel for client securities.

The ratio is also being implemented in Europe, but in the US, the required ratio is higher. There have been some discussions and proposals on increasing the leverage requirement for certain institutions in Europe.

LIQUIDITY COVERAGE RATIO (LCR) – HIGHLIGHTING HQLA

The LCR measures a firm’s short-term liquidity by comparing its high quality liquid assets (HQLA) to its net outflows over a 30-day stress period. For securities finance, the result is that borrowers are increasingly interested in term or evergreen securities lending transactions which are longer than 30 days. In addition, the LCR has created demand for collateral upgrade trades in which firms use non-HQLA or excess HQLA as collateral in order to borrow required HQLA.

US RISK BASED CAPITAL REQUIREMENTS – ALL LENDERS ARE NOT CREATED EQUAL

The Collins Amendment establishes a floor requiring certain large US bank holding companies to calculate risk weighted assets under both standardized and advanced approaches and meet minimum capital requirements under both approaches. Non-US institutions are not subject to the Collins Amendment.

The standardized and advanced approaches treat securities financing transactions differently. The standardized approach applies market and currency haircuts to the securities loaned and collateral received to determine the exposure amount of the transaction. The advanced approach provides more risk-sensitive calculations. Due to the Collins Amendment, financial institutions must follow the approach that produces the lower ratio.

In addition, different lenders (e.g., bank, non-bank) have different risk weights. To the extent that borrowers can transact with a lender that has a lower risk weight, such a transaction results in a lower risk-weight asset number. As a result, prior to a transaction taking place, borrowers are increasingly interested in knowing the participating lenders and are expressing preferences for certain types of lenders. This may lead to bifurcated pricing based on a lender’s risk weight.

LARGE EXPOSURES / COUNTERPARTY CREDIT LIMITS – CAPACITY CONSTRAINTS

Single counterparty credit limits, recently re-proposed in the US, could have a significant impact on large agent lenders and in turn, their beneficial owner clients. The indemnification that an agent lender provides to its underlying client is treated under these proposed rules as a credit exposure of the agent lender to the borrower. Further, the agent lender’s total exposure to any institution would include all affiliates and associated companies. The exposure limit for a global systemically important bank (G-SIB) to a non-G-SIB is twenty-five percent of tier 1 capital, but when a G-SIB deals with another G-SIB, that limit goes down to fifteen percent of tier 1 capital. G-SIBs include several agent lenders and most of the top borrowers in lending programs. So, as the large agent lenders near this fifteen percent limit, there could be capacity constraints on their ability to provide indemnification.

Effective January 1, 2018 with reporting begun on January 1, 2015

US Regulations finalized in September 2014. US firms began the LCR transition period on January 1, 2015 and are required to be fully compliant by January 1, 2017.

In December 2015 Basel published a second consultative document proposing revisions to the standardized approach for credit risk.

Basel standards finalized April 2014

Intended full implementation in January 2019

The comment period for the proposed US rules has just been completed, and there are advocacy efforts underway to seek a more risk-sensitive methodology for calculating exposures under securities financing transactions similar to the one that Basel has proposed. In addition, the US proposal seems to indicate that derivatives might receive a better treatment than securities finance transactions which could create regulatory arbitrage between the two types of transactions.

NET STABLE FUNDING RATIO (NSFR) – MORE DEMAND FOR NON-CASH COLLATERAL

The NSFR is a longer term liquidity measure of a firm's available stable funding over its required stable funding. For securities financing transactions, this ratio will require borrowers to raise long-term funding for a portion of a short-term securities financing transaction which will significantly add to the cost of that transaction. For example, the borrower has a hedge fund client which is shorting securities. The borrower will lend these securities to the hedge fund, and the hedge fund will give the borrower the cash proceeds from the short sale. This cash will be the borrower's available stable funding. The borrower will then pass that cash to the agent lender as collateral for borrowing the security. That cash (asset) will then have a required stable funding requirement. The credit that the borrower receives for the available stable funding of the cash that's given to them by the hedge fund is smaller than the required stable funding they need for the cash provided as collateral. This mismatch will significantly add to the cost of that transaction and may create further incentive for the increased use of non-cash collateral in securities financing transactions.

FINANCIAL STABILITY BOARD (FSB) – RECOMMENDATIONS LEAD TO REGULATIONS

The FSB workstream on securities lending and repo issued a series of recommendations covering collateral reuse, transparency, minimum haircuts and reinvestment of cash collateral. These recommendations have driven individual regulations across different jurisdictions. For example, Basel issued a proposal that integrated minimum haircuts for non-centrally cleared securities finance transactions into the capital rules. Not complying with these minimum haircut requirements will result in an unsecured exposure which is detrimental from a capital perspective.

The transparency recommendation has also given rise to additional regulations including the securities financing transaction reporting legislation in Europe. The Securities Financing Transactions Regulation (SFTR) will require the reporting of securities finance and repo transactions. In addition, when collateral in a securities finance transaction is taken under a transfer of title arrangement, the collateral receiver will have to provide notification of its intent with respect to the reuse of this collateral. The same notification may also apply to repurchase agreements in cash collateral reinvestment programs because that is also under a transfer of title arrangement.

As different jurisdictions roll out these transparency rules, clients and their agents may have to deal with duplicate reporting requirements.

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD) – A RING-FENCE AROUND AIF ASSETS

In Europe, regulators are attempting to segregate alternative investment fund (AIF) assets from other assets held by depositories and custodians. For securities finance transactions, the issue is whether this segregation is required at the subcustodial level. Currently, custodians utilize omnibus accounts with most subcustodians to hold assets in a local jurisdiction. These assets are allocated out to individual clients by means of books and records. If asset segregation is required at the subcustodian level, then individual accounts would be required for each AIF which would make securities lending more difficult for these funds. These individual accounts would increase the cost of securities financing transactions placing AIFs at a distinct disadvantage. AIFMD would have an impact on AIFs and their ability to engage and earn revenue in a securities lending program. This could also apply to UCITS funds.

CENTRAL SECURITIES DEPOSITORY REGULATION (CSDR) – TO BUY IN OR NOT TO BUY IN

Unlike the US rules and some of the jurisdictional rules, the European CSDR specifically includes securities lending and repurchase transactions in its proposed buy-in rules. This European regulation initiates mandatory buy-ins for failing transactions.

The NSFR will become a minimum standard by January 2018

ESMA is planning to consult in mid-2016 on draft technical standards for SFTR.

ESMA issued a consultation paper in December 2014. Industry is awaiting final ESMA guidelines to assess the full impact.

ESMA issued a consultation paper in June 2015. ESMA issued final report on draft regulatory standards on settlement discipline under CSDR regulation in February 2016.

The CSDR does exempt short-term transactions, so many securities finance transactions would not fall under this regulation. However, the increasingly popular term/evergreen securities financing transactions would be subject to CSDR buy-in requirements.

RECOVERY AND RESOLUTION REGIMES – WHAT HAPPENS WHEN A G-SIB DEFAULTS?

These regulations will require counterparties who transact with G-SIBs to agree to adhere to a document under which they agree to be bound by applicable jurisdictional stays on the exercise of termination rights and cross default rights. While lenders and agents will have some operational and administrative requirements, this should have a positive impact overall. If a G-SIB defaults, the regulators will likely come in at the holding company level allowing the operating subsidiaries to remain solvent. This will most likely result in an orderly unwind of securities finance transactions in which securities will be returned to the operating subsidiary and then back to the agent lenders.

US proposed rules apply to US law contracts with US counterparties unlike other jurisdictions that apply only to contracts governed by third-party law.

EUROPEAN FINANCIAL TRANSACTION TAX – THE FUTURE IS UNCLEAR

As it's currently proposed, the European FTT includes securities lending and repo transactions, and this proposal will have an extra-territorial reach and could affect transactions outside the member states on a global scale. Under the FTT, there will be the potential for increased transaction costs for borrowers and potential increased reporting, withholding and payment requirements for agent lenders. For beneficial owners, there could be reduced demand for securities lending and hence fewer revenue opportunities. There has not been much activity around the FTT in recent months, however, the debate continues.

Regulation and Securities Finance

The relationship between regulation and securities finance is complex and continues to change. Some rules have been finalized, but regulators are returning to them to calibrate certain details or refine calculations. Other regulations have yet to be fully implemented and jurisdictional differences can complicate this implementation. How this relationship evolves will have a significant impact on the financial marketplace and will continue to be a major topic of discussion in years to come.

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PRA issued consultation on Contractual Stays in Financial Contract Governed by Third-Party Law in May 2015.

German Single Resolution Mechanism implemented into law and became effective January 2016.

In February 2013, the European Commission (EU) issued a proposal for a common financial transaction tax that would be applied by participating EU member states.

For more information on BNY Mellon securities finance capabilities or to continue this discussion of regulation and its effect on securities finance, please contact us.

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