

ICI VIEWPOINTS

JANUARY 17, 2013

Securities Lending and Repos: FSB Intrudes on Areas Best Left to National Regulators, Market Forces

By Robert Grohowski and Giles Swan

The Financial Stability Board (FSB), the international body established by the G20 to promote coordination among authorities responsible for financial stability, has made a number of recommendations toward creating a global policy framework for the securities lending and repurchase agreement (repo) markets. These efforts are a part of the FSB's agenda on the so-called [shadow banking](#) issue.

ICI and ICI Global strongly support the FSB's work in identifying and addressing systemic risks in the securities lending and repo markets. However, in recent letters ([ICI](#) and [ICI Global](#)) we've urged the FSB to step back from certain recommendations that, in our view, inappropriately intrude on areas best left to market forces, national regulators, or regional regulators.

Background

Securities lending and investments in repos are two investment techniques that funds use to improve the return on their portfolios for the benefit of their shareholders.

- **Securities lending:** As the name implies, securities lending involves a loan of securities owned by one party (the beneficial owner of the securities) to another party (the borrower). The borrower gives the lender collateral to secure the loan. Due to strict regulatory limits, securities lending is a relatively minor strategy for most publicly available regulated funds, designed to add incremental returns with minimal additional risk. Regulated funds are most often beneficial owners of the securities being lent, taking and reinvesting cash collateral.
- **Repos:** A repurchase agreement, also known as a repo, involves the sale of securities together with an agreement for the seller to buy back the securities later at a slightly higher price. The securities sold collateralize the repo. Investments in repos may be a more prominent strategy for some regulated funds, particularly money market funds. Funds that enter into repos do so only with high-quality counterparties, and most frequently enter into repos as a collateralized short-term cash investment (i.e., they begin and end the transaction with cash).

The Financial Stability Board has focused on this area [since 2011](#). Our letters respond to a [November 2012 consultation](#) from the FSB, which sets forth the proposed framework. That consultation followed an [Interim Report](#) published last April.

Key Issue #1: Fund Disclosure Is an Area Best Left to National Regulators

Most of the FSB's consultation is focused, as it should be, on identifying and addressing systemic risk concerns. In some spots, however, the FSB strays from this mandate and makes recommendations on topics that are best left to regional or national authorities.

The FSB's recommendations on fund manager disclosure to end-investors on securities lending and repo are a prime example. Without attempting to draw any link to systemic risk concerns, the FSB lists 24 separate pieces of information that *could be* useful to end-investors and recommends that authorities consider revising their local disclosure requirements for fund managers accordingly.

We have strongly supported improvements to fund disclosure over the years, as well as appropriate disclosure with respect to securities lending, repos, and other investment strategies and techniques. Fund managers should be required to disclose information

necessary to allow investors to select investments with due consideration of the risks taken by the fund.

But policy decisions about the contours of that disclosure should be left to each national regulator's discretion to determine. If, for example, the U.S. Securities and Exchange Commission concludes that fund disclosure about securities lending is lacking, it can (and should) propose additional disclosure requirements. Indeed, European regulators recently did just this. Absent systemic risk concerns, however, the FSB should defer to national or regional regulators' judgment on that front.

Key Issue #2: The Market Should Determine Repo Terms Such as Haircuts

We have a different set of concerns with the FSB's recommendations on repo "haircuts" (an amount subtracted from the market value of the repo collateral). In this case, the FSB arguably has identified systemic risk concerns. Its response, however, is to propose that regulators dictate a key economic term in repos: the haircut level for collateral.

We oppose this idea for a number of reasons.

- We fundamentally disagree with any attempt to regulate the negotiated terms of market transactions, such as repos.
- Focusing on collateral haircuts is misplaced and ignores the economic reality of a repo, which is that buyers enter into a repo based primarily on the seller's capacity to pay the repurchase price—not the collateral involved.
- The idea that regulators would dictate specific numerical floors for haircuts—at the very high levels suggested by the FSB—raises a host of concerns, all of which are correctly identified and acknowledged in the consultation itself.

We invite you to read our complete letters, which touch on many more issues. For much more on international regulatory developments affecting funds, visit the [policy priorities section](#) of ICI Global's website.

Bob Grohowski was a Senior Counsel at ICI.

Giles Swan is director of global funds policy at ICI Global.