



Draft European Commission Regulation on transparency of securities financing transactions. July 2014.

The European Commission adopted, on the 29th of January 2014, a **proposal for a regulation aimed at increasing transparency of certain transactions outside the regulated banking sector**. This proposal provides a set of measures to enhance regulators' and investors' understanding of securities financing transactions (hereinafter SFTs). These transactions have been a source of contagion, leverage and procyclicality during the recent financial crisis and they have been previously identified in the Commission's Communication on Shadow Banking -dated on 4 September 2013- as needing better monitoring.

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 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.

SFTs include a **variety of secured transactions** that have similar economic effects such as lending or borrowing securities and commodities, repurchases (repos) or reverse repurchases transactions, and buy-sell back or sell-buy back transactions. 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.

The proposal aims to **improve the transparency** of securities financing transactions (SFTs). Transparency is important in understanding how the SFTs market works, what the risks are and what their magnitude is and, in this respect, transparency provides the information necessary to develop effective and efficient policy tools to prevent systemic risks. The improvement of transparency will be achieved by:

1. the proposed regulation would require that all transactions are reported to a central database. This would allow supervisors to better identify the links between banks and shadow banking entities and would shed more light on some of their funding operations. As a consequence, supervisors would be able to monitor the exposures to and risks associated with SFTs and, if necessary, take better-targeted and timelier actions.
2. the proposed regulation would improve transparency towards investors on the practices of investment funds engaged in SFTs and other equivalent financing structures by requiring detailed reporting on

these operations, both in the regular reports of funds and in pre-investment documents. This would lead to better-informed investment decisions by investors.

3. the proposal would improve the transparency of the rehypothecation (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 would ensure that clients or counterparties have to give their consent before rehypothecation can take place and that they make that decision based on clear information on the risks that it might entail.

The proposal of Regulation **estimated benefits for regulators and investors** can be described as follow:

First, the reporting of SFTs to trade repositories would allow supervisors to better identify links between banks and shadow banking entities. It would also shed more light on the funding operations of shadow banking entities. Supervisors and regulators would then be able to monitor the market and, if necessary, design better-targeted and timely actions to address any risks to financial stability that emerge.

Second, transparency in the use of SFTs by investment funds is vital. At present, there is very little information available on the use of these transactions by funds, in particular with regard to securities lending and total return swaps. The disclosures required by the draft Regulation would therefore not only benefit investors, but also enable regulators to access valuable information. This, in turn, would allow them to assess the risk linked to the use of these instruments and propose further measures if necessary.

Finally, the harmonised rules with respect to rehypothecation would limit potential financial stability risks with the removal of uncertainty about the extent to which financial instruments have been rehypothecated.

If you want to read the proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions, please, do click on: http://eur-lex.europa.eu/resource.html?uri=cellar:b2522602-8f15-11e3-b19c-01aa75ed71a1.0001.01/DOC_1&format=PDF