

# Strengthening regulation and oversight of shadow banking

## FSB issues regulatory framework for haircuts on non-centrally cleared securities financing transactions

On 14 October 2014, the Financial Stability Board issued a regulatory framework on haircuts for non-centrally cleared securities financing transactions. The framework sets out what the FSB calls ‘qualitative standards’ for the methodologies used to calculate ‘haircuts’ and, for the first time, seeks to impose minimum haircuts – numerical haircut floors – to be used by firms providing finance to non-banks.

This is the latest move by the Financial Stability Board (FSB) to reduce perceived shadow banking risks in securities lending and repo markets and follows on from the policy recommendations in this area issued in August 2013, the feedback from the subsequent consultation paper and two Quantitative Impact Studies (QIS).

However, this latest development is not the last word on haircuts, as further work is envisaged, particularly on minimum haircut floors. The current proposals apply only to transactions where finance is provided to non-banks (e.g. from a bank or broker-dealer to a hedge fund). Mindful of the risk of pushing more activities into the shadow banking sector, and of the need to maintain a level playing field, the FSB intend extending the requirements on numerical haircut floors to transactions between non-banks. This is subject to consultation which closes on 15 December 2014. It is also possible that, in the future, regulators may raise the level of haircut floor above those that have been set out as a macro-prudential tool, although the FSB acknowledges that further work would be needed to implement this.

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Aside from further work by the FSB, national regulators will have to consider how to implement the framework as, to come into force, it will have to be transposed into national regulatory regimes. For this reason, the precise requirements and implementation strategies are not known at the present time, which, of course, leaves many unanswered questions.

So there is more to come and the market will be watching closely, particularly with regard to how these new rules might operate on a cross-border basis, as successful implementation hinges on a consistent and harmonised global approach. It remains to be seen whether this will be achieved. Judging by the experience in other markets, OTC derivatives in particular, it may not be straightforward.

In this briefing, we summarise the FSB’s proposals on haircuts and consider the likely impact on securities financing markets.



### Haircut Framework – Key Facts

- Qualitative standards for haircut methodologies to be used by all SFT market participants
- Numerical haircut floors where finance is provided to non-banks, against non-government securities
- Implementation end of 2017
- Monitoring framework to be put in place
- Consultation on extending the proposals on numerical haircut floors to transactions between non-banks closes on 15 December 2014

## The regulatory framework for haircuts

The framework consists of two complementary parts:

- Qualitative standards to be incorporated into existing or new regulatory standards for methodologies used by all market participants to calculate haircuts on collateral received
- A framework of numerical haircut floors, that will apply to non-centrally cleared securities financing transactions (SFTs) in which financing against collateral other than government securities is provided to non-banks

Centrally-cleared SFTs and financing provided to banks and broker-dealers subject to adequate capital and liquidity regulation on a consolidated basis are excluded.

The policy objective behind the framework is to limit the build-up of excessive leverage outside the banking system and reduce the pro-cyclicality of that leverage with, for example, the numerical haircut floors functioning as a backstop in a benign market environment. It largely follows proposals in the FSB August 2013 paper, although the numerical haircut floors have been raised in some cases.

It should be noted that the scope of each part of the framework is different: the qualitative standards apply to all market participants undertaking SFTs; the minimum haircuts apply only where finance is provided to non-banks against non-government bond collateral.

The framework is to be implemented by the end of 2017. For this to happen, the framework must be incorporated into national regulatory regimes and the FSB recommends ways for this to be done. At this stage, therefore, we do not know

the precise requirements on haircuts or how they will operate on a day-to-day basis, as this will depend on national implementation. One of the key objectives, acknowledged by the FSB, will be to ensure that the requirements are implemented consistently on a global basis.

## Qualitative standards for methodologies used to calculate haircuts

As a matter of best practice, firms should already have robust risk management policies in place if they undertake SFTs, an important part of which is having an appropriate methodology to calculate the level of 'haircut' – the discount applied to the value of securities given as 'collateral' for a cash 'loan'. By the end of 2017, regulators must set qualitative standards for such haircut methodologies, in line with FSB guidance, which firms must meet, the aim being to improve the quality and consistency of setting haircuts across the securities financing markets. Further information on the qualitative standards is shown in Appendix 1.

In order to meet the implementation target, the FSB recommends a two step process whereby standard setters (such as the BCBS) review existing regulatory requirements for the calculation of collateral haircuts to ensure that they are in line with the FSB recommendations by the end of 2015, with regulators then setting the

regulatory requirements, in line with these standards and FSB guidance, by the end of 2017.

It is too early to tell precisely how the requirements might be implemented as more information is required. Although they are quite detailed, many of the terms, such as 'high confidence level', are not defined, so it is difficult to know precisely what they mean. In addition, as with all the 'policy proposals' on shadow banking, there is scope for divergence in national implementation which could pose problems for firms operating on a cross-border basis.

## Numerical haircut floors

The framework of numerical haircut floors applies to non-centrally cleared SFTs where finance is provided to non-banks against collateral other than government securities. There are several important exceptions – securities finance received by banks and broker-dealers subject to adequate capital and liquidity regulation on a consolidated basis is excluded from the scope of the numerical haircut floors, as are transactions backed by government debt. Non-centrally cleared securities financing transactions performed in any operation with central banks are also outside the scope of application.

As the haircut floors set out in the framework are not intended to be market standards, firms should conduct their own assessment of the appropriate haircuts to apply in particular

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circumstances, in accordance with the qualitative methodology criteria, and to set higher haircuts where prudent.

Firms providing finance to non-banks, such as banks and broker-dealers, will be affected by the haircut floor requirements on a day-to-day basis as

they will have to incorporate them into their haircut policies. Non-bank entities which typically obtain short-term finance through the markets may find it more expensive to obtain finance in the future. Notably, as minimum haircut requirements do not apply to transactions between banks and government debt is excluded, there is likely to be no direct impact on the inter-bank repo market. Likewise, central bank repo arrangements will not be affected.

### Levels of numerical haircut floors

The numerical haircut floors are shown in Table 1. They are intended to apply at the transaction level and where margin is applied at the portfolio level.

**Table 1: Numerical haircut floors for securities-against-cash transactions<sup>1</sup>**

Residual maturity of collateral	Haircut level	
	Corporate and other issuers	Securitised products
≤ 1 year debt securities, and Floating Rate Notes (FRNs)	0.5%	1%
> 1 year, ≤ 5 years debt securities	1.5%	4%
> 5 years, ≤ 10 years debt securities	3%	6%
> 10 years debt securities	4%	7%
Main index equities	6%	
Other assets within the scope of the framework	10%	

Source: FSB

<sup>1</sup> Where shares in mutual funds are used as collateral to securities financing transactions, they should be treated as 'other assets'.

The haircuts have been calibrated at levels above those proposed in the August 2013 consultation paper, taking into account the results of the two-stage QIS, data on the historical price volatility of in-scope assets, as well as existing market and central bank haircuts. An additional maturity bucket for debt securities with a residual maturity of more than ten years has also been introduced.

In an attempt to ensure a coherent approach across different sectors of the financial markets, the numerical haircut floors are based on a variant of the Basel III standard supervisory haircuts for securities financing transactions. The BCBS is currently reviewing these and plans to reflect the regulatory framework on haircuts set out by the FSB (including the numerical haircut floors) in its review. This will have the important benefit of consistency with capital rules and with the standardised schedules adopted by the BCBS-IOSCO margin requirements for non-centrally cleared derivatives.

Although the minimum haircut requirements have been increased from the levels shown in the earlier consultation, overall they appear proportionate and, generally speaking, have not provoked a strong reaction in the market. Firms have tightened up their margin requirements in response to the problems seen during the financial crisis and, to some extent, may have already factored in regulatory requirements in this area. If that is the case, the minimum haircuts are unlikely to have a dramatic impact in the short term. The FSB itself has acknowledged that it expects only a ‘minimal impact’ on market volume from its proposals, perhaps mindful of imposing rules likely to have an adverse impact on liquidity. The dilemma for policy makers is how to tighten up regulation in this area without choking off the liquidity which is essential for growth, particularly at a time when many economies, especially

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in the Eurozone, are struggling with strong deflationary pressures.

#### **Cash-collateralised securities lending**

The framework of numerical haircut floors is intended to apply to transactions where the primary motive is to provide financing, rather than to borrow or lend specific securities. Therefore, cash-collateralised securities lending transactions are exempt from the framework of numerical haircut floors where:

- securities are lent at long maturities and the lender of securities reinvests or employs the cash at the same or shorter maturity, therefore not giving rise to material maturity or liquidity mismatch
- securities are lent at call or at short maturities, giving rise to liquidity risk, only if the lender of the securities reinvests the cash collateral into a reinvestment fund or account subject to regulations or regulatory guidance meeting the minimum standards for reinvestment of cash collateral by securities lenders set out in Section 3.1 of the August 2013 Report. For this purpose, counterparties may rely on representations by securities lenders that their reinvestment of cash collateral meets the minimum standards.

Implementing these requirements is likely to be complicated and the market will need to find a consistent way to do this. Verifying whether an individual cash collateralised securities lending transaction meets the conditions referred to above, and would therefore be exempt from the minimum haircut requirements, will

necessitate securities borrowers (who provide the cash collateral) establishing how the cash will be used by the securities lenders (who take the cash collateral). In some cases the borrower may rely on representations from the lender that their re-investment of cash collateral meets the minimum standards. The securities lending market needs to establish how to do this, perhaps by amending market standard documents and issuing best practice guidance.

#### **Special Repos**

‘Special repos’ (or specials) on collateral other than government securities are within the scope of the haircut floors, the rationale being that although special repos are also used for borrowing and lending specific securities, the cash borrower typically uses the cash for financing purposes.

#### **Collateral upgrade transactions**

‘Collateral upgrade’ transactions which involve borrowing securities in Table 1 against other securities in Table 1 that attract higher haircuts are within the scope of the haircut floors. For this type of transaction, the floors would be equal to the difference between the floors that would be applied to repos of the collateral types on the two legs of the transaction, if they had been done separately.

However, securities lenders ‘could be exempted’ from the numerical haircut floors on ‘collateral upgrade’ transactions if they are unable to re-use, or provide representations that they do not and will not re-use, the securities received as collateral against the securities lent.





No doubt the market will be seeking further clarity in this area, particularly with regards to the circumstances when lenders 'could be exempt'. Again, putting these requirements into practice, particularly across large and complex trading books, may not be straightforward.

## Implementation

The FSB is a standard setting body, so to take effect the regulatory framework for haircuts must be implemented by national regulators. The FSB paper discusses three possible implementation approaches: entity based regulation, product based regulation and a hybrid of the two, echoing previous work by FSB workstreams 3 and 5 on securities lending and repo.

For non-centrally cleared securities financing transactions in which banks and broker-dealers provide finance to non-banks against collateral other than government securities, the FSB recommends, as a first step, that the BCBS should review its capital treatment of securities financing transactions and incorporate the framework of numerical

haircut floors into the Basel III framework by the end of 2015.

Following the BCBS's incorporation of the framework of numerical haircut floors into the Basel III framework, authorities must then implement the framework by the end of 2017. That may be either through the Basel III framework (for example, by imposing higher capital requirements for transactions that do not comply with the numerical haircut floors) or by requiring banks in bank-to-non-bank transactions to conduct transactions above the numerical haircut floor or collect minimum excess margin amounts consistent with the numerical haircut floors. Such a requirement could be directed solely at banks and broker-dealers (i.e. entity-based regulation) or could be encompassed within a requirement that applies on a market-wide basis (i.e. market regulation). To the extent that market regulation also captures non-bank-to-non-bank transactions, this would have to take into account the findings of the consultation which has just been initiated. This must also be implemented by the end of 2017.

## Overlap with derivatives

In order to ensure a consistent approach across collateralised products, the rules on haircuts for SFTs are to be aligned with those in other sectors, such as OTC derivatives. In addition, the FSB intends to work closely with the BCBS-IOSCO monitoring group on the margin requirements for non-centrally cleared derivatives so as to minimize potential arbitrage between the two regimes. Further information on how this might work will be published shortly, as details

of the monitoring process are expected to be published by Q2 2015.

## Monitoring and review

In order to ensure that the haircut framework is implemented in a consistent manner globally, a monitoring framework is to be established. The FSB is already working on an initiative to gather global securities financing data and it is contemplated that monitoring haircuts be incorporated into that exercise. More information will be available shortly, as the proposed standards and processes for global securities financing data collection and aggregation will be developed by November 2014 and will be issued for public consultation.

## Next steps

The FSB have launched a consultation on extending the proposals on numerical haircut floors to non-bank-to-non-bank transactions. Details of the proposals are set out in Annex 4 to the regulatory framework. The consultation closes on 15 December 2014.

## What should firms do to prepare?

Although precise details are not known at the present time, the thrust of the requirements is clear. Market participants should begin to compare their current practices to the framework, identifying any new requirements or areas that are likely to need amending, with the aim of establishing internal procedures for setting haircuts that are in line with the proposed framework.

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## Appendix 1 – Qualitative Standards on Haircut Methodologies – FSB Recommendations and Guidance

### Standards for methodologies to calculate haircuts on an individual asset basis

**Haircuts should be based on the market risks of the assets used as collateral and be calibrated at a high confidence level, using a long historical time period that includes at least one stress period, in order to cover potential declines in collateral values during liquidation**

- Haircut methodologies should be designed to limit potential procyclical fluctuations in haircuts, specifically by moderating the extent to which they decline in benign market environments
- Haircuts should be set to cover, at a high level of confidence, the maximum expected decline in the market price of the collateral asset, over a conservative liquidation horizon before a transaction can be closed out
- Haircuts may be calculated either on a transaction level basis or at the collateral portfolio level
- Haircut methodologies should not be based on a rolling short window, e.g. two years or less, of recent price data
- The maximum price decline used to derive the applicable haircut should be calculated using a long time series of price data that covers at least one stress period
- If historical data is unavailable or unreliable, stress simulations or data for other similar asset types as a proxy (including at least one stress period and with prudent adjustments made as appropriate) should be used
- Where feasible, historical bid-ask spreads and pricing uncertainty should be examined to consider the possibility that stressed market conditions may lead to a widening of bid-ask spreads and a reduction in the market liquidity of a given type of collateral
- The assumed liquidation horizon should be conservative, reflect the expected liquidity or illiquidity of the asset in stressed market conditions, and depend on the relevant market characteristics of the collateral, such as trading volumes and market depth

### Haircuts should capture other risk considerations where relevant

- Haircuts should also take into account other relevant risk considerations, such as the risk of liquidating large concentrated positions (liquidation risk) and the ‘wrong-way risk’ between collateral value and counterparty default
- Specific characteristics of the collateral, which include asset type, issuer creditworthiness, residual maturity, price sensitivity (such as modified duration), optionality, complexity of structure, expected liquidity in stressed periods and the frequency of collateral valuation and margining, should also be taken into account
- The creditworthiness of, and existing exposures to, counterparties may also be considered as additional factors in setting the appropriate haircut over and above the haircut derived from collateral-specific considerations
- Haircuts should also factor in the foreign exchange risk in cases where there is a currency mismatch between the currency of denomination of the collateral and the counterparty exposure (e.g. cross-currency repos). The historical volatility of the exchange rate for the relevant currency pair, including in stress periods, should be used to determine the additional haircut required in such cases
- The correlation between securities accepted as collateral and securities loaned in securities lending transactions should also be taken into account, where relevant

### Additional guidance for methodologies to calculate haircuts on a portfolio basis

- Methodologies for portfolio margin calculation should not be procyclical
- Methodologies should not lead to an automatic decline in margin requirements as the prices of assets in the portfolio increase or as the (actual or implied) volatility of asset prices in the portfolio decreases
- When setting margin requirements for different counterparties and portfolios, market participants should consider the following:
  - market risk of the portfolio
  - portfolio concentration by geographies, economic sectors and individual issuers
  - illiquidity of the portfolio
  - risks arising from non-correlated price and spread relationships between lent securities and collateral portfolio assets
- Methodologies should include robust stress testing of margin requirements against a range of historical and hypothetical stress scenarios, designed or selected with due consideration to the particular characteristics of the portfolios being stress tested
- Regular back testing of margins should also be carried out
- Appropriate internal processes and procedures must be in place when firms calculate margin on a portfolio basis
- Processes and procedures should be well-documented, source reliable prices and parameters, and include robust controls to identify any shortfalls in the margin methodologies
- Regulators should consider testing the adequacy of margin methodologies used by market participants.

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