EU Regulation

TRANSPARENCY OF SECURITIES FINANCING TRANSACTIONS

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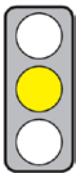
Centrum für Europäische Politik

KEY ISSUES

Objective of the Regulation: The Commission wants to introduce a standard EU reporting obligation for securities financing transactions, tighten rules on the rehypothecation of securities and extend the information requirements for investment funds.

Affected parties: All companies based in the EU, particularly banks, shadow banks and trade repositories.



Pro: The reporting obligation for securities financing transactions increases the transparency of credit interconnectedness in the financial market. This is necessary in order to recognise potential risks at both the micro-prudential and macro-prudential level.

Contra: (1) The added value of tightening the rules on rehypothecation is small. The additional information requirements for UCITS and AIFMs only provide a theoretical contribution to investor protection.

(2) The Commission's power to change the scope of the Regulation by way of delegated acts is in breach of EU law.

CONTENT

Title

Proposal COM(2014) 40 of 29 January 2014 for a **Regulation** of the European Parliament and of the Council on **reporting and transparency of securities financing transactions**

Brief Summary

- **Objectives and context**
  - The Commission wants to make the interconnectedness of credit between the regulated banks and less regulated financial institutions ("shadow banks", see cep**PolicyBrief**) more transparent (Recital 6). For this it wants to
    - introduce a reporting obligation for "securities financing transactions",
    - set up standard EU requirements for trade repositories to which the reports are submitted,
    - tighten the rules on the rehypothecation of securities and
    - require investment funds to inform investors about securities financing transactions and about rehypothecation.
  - The provisions will supplement the Regulation on structural measures in the banking sector [COM(2014) 43, see cep**PolicyBrief**] submitted at the same time (Recital 5).
  - With this Regulation, the Commission is implementing the Recommendations of the Financial Stability Board (FSB) of 29 August 2013 and wants to prevent divergent national measures in the EU (Recital 7).
  - In order to keep the cost of reporting "as low as possible" for the market operators, this Regulation is based on the EMIR Regulation (EU) No. 648/2012; see cep**PolicyBrief**) requiring the reporting of derivatives contracts.

- **Definitions and Scope of the Regulation**
  - "Securities financing transactions" include (Art. 3 No. 6)
    - repurchase transactions, i.e. any purchase or sale which is subject to a repurchase obligation involving
      - securities and goods or
      - guaranteed legal rights to securities or goods
    - borrowing and lending transactions involving securities or goods in return for a fee (non-cash lending) and
    - transactions with equivalent economic effect and similar risks.
  - "Rehypothecation" refers to the use of financial instruments received as collateral such as for subsequent securities financing transactions (Art. 3 No. 7).
  - "Counterparties", i.e. the contracting parties, are (Art. 3 (2) in conjunction with Article 2 Regulation (EU) No. 648/2012)
    - financial counterparties such as banks and insurance companies,
    - non-financial counterparties, such as all other companies,
    - central counterparties, i.e. companies that interpose themselves between the buyer and the seller in financial contracts and handle the financial transactions in return for a fee.

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– The Regulation applies to (Art. 2 (1))
  - counterparties established in the EU including all their branches outside the EU,
  - counterparties established outside the EU if they
    - conclude securities financing transactions via an EU branch, or
    - are involved in a rehypothecation of financial instruments which a counterparty, established in or with a branch in the EU, has provided as collateral.
– The Regulation does not apply to (Art. 2 (2))
  - the Bank for International Settlements (BIS) and the central banks of the EU,
  - public bodies in the EU responsible for the management of public debt.
– The Commission can adopt delegated acts to exclude other counterparties from the Regulation or to include those which have been left out (Art. 2 (3)).

► **Reporting obligations for securities financing transactions**
– All counterparties to a securities financing transaction must (Art. 4 (1), sub-paragraph 1 and (2))
  - report the details of the transaction to a trade repository no later than one day after conclusion, modification or termination of the transaction,
  - keep a record of terminated transactions for at least ten years.
– Both counterparties to the securities financing transaction may "delegate" the reporting to another company (Art. 4 (1), sub-paragraph 3).
– By way of regulatory technical standards, the European Securities and Markets Authority (ESMA) regulates the details of the different types of securities financing transactions which have to be reported, in particular (Art. 4 (7)
  - the identity of the counterparties,
  - the principal amount, currency, quality and value of collateral, if the collateral has already been rehypothecated, the repurchase rate or lending fee and maturity date.
– ESMA regulates, by way of technical implementation standards, the format and frequency of reporting for the various types of securities financing transactions (Art. 4 (8)).

► **Standard EU requirements for trade repositories**
– Trade repositories must apply to ESMA for registration which applies throughout the whole of the EU ("EU Pass"). ESMA carries out the supervision of all trade repositories (Art. 5 (1), (2) and (4)).
– Trade repositories based in a non-EU country may submit an application to ESMA for recognition. For EU authorisation the trade repository must be subject to effective supervision in the non-EU country. (Art. 19 (3))
– Trade repositories must (Art. 12 (1) and (2))
  - regularly publish aggregated information about the individual categories of securities financing transactions reported to it,
  - allow the EU authorities referred to in the Regulation to have direct and immediate access to details which have been reported about the securities financing transactions.

► **Tightening of the requirements for the rehypothecation of securities**
– A counterparty can only rehypothecate a received security where it (Art. 15 (1) (a) and (b) and Art. 15 (2) (b)
  - has informed the counterparty which originally provided the security, in writing, of the risks involved in a rehypothecation and
  - has obtained the express consent of this counterparty to the rehypothecation and
  - transfers the financial instruments received as collateral to a separate account.
– Stricter sector-related provisions, in particular the Directive on Alternative Investment Fund Managers (AIFM, 2011/61/EU, see cep**PolicyBrief**) and the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS, 2009/65/EC, see cep**PolicyBrief**) continue to apply (Art. 15 (3)).

► **Information to be provided by investment funds to investors**
– Prior to conclusion of the contract, managers of UCITS and AIF must provide investors – in the case of UCITS, in the prospectus - with the following information in particular (Art. 14 (2) in conjunction with Section B of the Annex)
  - a general description of the securities financing transactions made, the criteria for choosing counterparties,
  - methods of assessing the value of collateral, the use of profits generated by securities financing transactions.
– After conclusion of the contract, manager of UCITS must inform their investors on a half-yearly basis, manager of AIF annually, about (Art. 13 in conjunction with Section of the Annex)
  - the proportion of assets integrated into securities financing transactions, the ten most important counterparties for each category of securities financing transactions and the proportion of rehypothecation carried out by comparison with the maximum figure shown in the prospectus.

- Unlike the other provisions of the Regulation, these information requirements apply not only to securities financing transactions but also to "similar financing structures" (Art. 13 (2)).
- The Commission can adopt delegated acts stipulating additional information which has to be published (Art. 13 (3) in conjunction with Art. 27).

- **Sanctions**
  - In the case of breaches of the reporting obligation or of the requirements in the case of rehypothecation, the authorities can impose "administrative sanctions", in particular, pecuniary sanctions. (Art. 20 (1) and (4) (d), (h) and (i).
  - A breach of the reporting obligation does not affect the validity of the securities financing transaction (Art. 20 (5)).

Main Changes to the Status Quo

- Until now, banks and investment firms had to report to the regulatory authorities, at least in summarised form, inter alia the level of repurchase agreements and securities lending transactions [Art. 100, page 1 CRR Regulation (EU) No. 575/2013, s. cep**PolicyBrief**]. In future they will have to report all securities financing transactions individually.
- Until now, investment firms had to report "financial instruments transactions" to the regulatory authorities [Art. 25 MiFID I Directive (2004/39/EC), Art. 26 MiFIR (Regulation (EU) No. 600/2014)] but securities financing transactions were exempt from this reporting obligation [Art. 5 MiFID I Implementation Regulation (EC) No. 1287/2006]. In future they will also have to report all securities financing transactions.
- Until now, counterparties had to report derivatives contracts to a trade repository [Art. 9 (1), sub-paragraph 1 EMIR Regulation (EU) No. 648/2012, see cep**PolicyBrief**]. In future they will also have to report securities financing transactions.

Statement on Subsidiarity by the Commission

According to the Commission, the cross-border network of shadow banks and their systematic impact on financial stability requires coordinated action by the EU.

Policy Context

In March 2012, the Commission published a Green Paper on shadow banking in which it looked at the identification and monitoring of all shadow banks and their activities [COM(2012) 102, see cep**PolicyBrief**]. A Communication on shadow banking followed in September 2013 [COM(2013) 614].

Legislative Procedure

29 January 2014	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Internal Market
Leading Committee of the EP:	TBA
Leading Federal Ministry:	Ministry of Finance
Leading Committee of the BT:	Finance
Decision-making mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (Ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The tightening of EU financial markets regulation - BRRD (see cep**PolicyBrief**), CRR and CRD IV (see cep**PolicyBrief**) as well as the proposed structural measures in the banking sector [COM(2014) 43, see cep**PolicyBrief**] - increases the incentive for banks to outsource their yield-enhancing securities financing transactions and other structured credit transactions, entered into with other banks or shadow banks, to companies set up especially for that purpose. The regulatory authorities are unable to fully monitor the resulting risks because they have no regulatory mandate for the banks' special-purpose companies or for other shadow banking companies. Ultimately, however, the risks of securities financing transactions can arise due to the interconnectedness of banking credit.

The planned reporting obligation for securities financing transactions increases the transparency of the interconnectedness of credit on the financial markets **– particularly with shadow banks. This is necessary in order to recognise potential risks at both the micro-prudential and macro-prudential level.**
A bilateral reporting obligation does not contribute substantially to the quality of the underlying data. Although a bilateral reporting obligation - by comparison with a unilateral reporting obligation - makes it more difficult to conceal securities financing transactions, it is questionable whether this alone justifies the additional costs arising for both counterparties as a result of the reporting. Alternatively, a unilateral reporting obligation could be introduced with heavy sanctions for failure to comply. In this regard, one should wait to see what can be learned from the bilateral reporting obligations for derivative contracts (EMIR Regulation (EU) No. 648/2012, see cep**PolicyBrief**).

The added value of tightening the rules on rehypothecation is small. Although they increase the counterparties' awareness of the possible loss of their collateral, in the case of most securities financing transactions, namely repo transactions and securities lending, the information requirement and prior consent to rehypothecation of the collateral, are already incorporated as standard in framework contracts.

The additional information requirements for UCITS-funds and AIF only provide a theoretical contribution to investor protection. AIF are generally taken up by professional investors. These have sufficient negotiating power to demand information even where there is no statutory duty to provide it. UCITS investment funds are generally taken up by private investors who often do not understand the information provided. In addition, a large number of different transparency provisions already exist, such as in the UCITS Directive (2009/65/EC, see cep**PolicyBrief**). To safeguard regulatory consistency, the new information requirement should be inserted there.

Legal Assessment

Legislative Competency

The Regulation is correctly based on the internal market competence (Art. 114 TFEU). Although, according to the Commission, there are not yet any national rules on the transparency of securities financing transactions which correspond to the FSB recommendations of 29 August 2013, the internal market competence can also be used in order to "prevent an uncoordinated development of national rules" if the emergence of obstacles to the internal market is likely and the measure in question aims to prevent it (ECJ, joint cases C-154/04 and C-155/04 and Case C-491/01). The Regulation is based on the recommendations of the FSB whose members are obliged to implement those recommendations. In addition to the EU, some Member States are also direct members of the FSB. The Commission therefore correctly assumes that these Member States will "probably adopt varying national measures" which could obstruct the internal market (cf. ECJ Case C-217/04 para. 60 et seq.).

Subsidiarity

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

The power of the Commission to exempt, by way of delegated acts, undefined counterparties from the scope of the Regulation, or to include those which have been left out, is in breach of the EU law on the adoption of delegated acts (Art. 290 TFEU) requiring "essential elements of an area" to be regulated in legislative acts. Its scope defines the people affected by the Regulation and is therefore essential.

Impact on German Law

As from January 2015, UCITS and AIFMs must provide the Bundesbank with monthly information on their securities lending and repurchase transactions (Communication No. 8003/2013 on the basis of Section 18 Bundesbank Act). As a result of the Regulation, they will now additionally have to notify a trade repository about these transactions and about their other securities financing transactions.
By contrast with the Regulation, investment service providers in Germany also have to report to the regulatory body on pseudo-repurchase agreements, i.e. repurchase agreements with no repurchase obligation (Rule of the Federal Financial Supervisory Authority (BaFin) contained in the BaFin Circular 11/2008).

Conclusion

The planned reporting obligation for securities financing transactions increases the transparency of credit interconnectedness. This is necessary in order to recognise potential risks at both the micro-prudential and macro-prudential level. The added value of tightening the rules on rehypothecation is small. The additional information requirements for UCITS and AIFMs only provide a theoretical contribution to investor protection. The Commission's power to change the scope of the Regulation by way of delegated acts is in breach of EU law.