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Asset Management & Investment Funds

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Post-Crisis Regulation Continues With Revised Recommendations To Limit Leverage Build-Up In SFTs

On 26 November 2019, the Financial Stability Board (FSB) published a revised version of its "Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions" (**2019 Framework**). The 2019 Framework consists of several recommendations, aimed principally at limiting the contribution of SFTs to the build-up of leverage, "as shown during the emergence of the financial crisis in 2007-2008". One such recommendation is for the application by regulatory authorities of numerical haircut floors on non-centrally cleared securities financing transactions (**SFTs**). A haircut is a discount applied to the value of collateral provided, in order to account for market risk. Haircuts aim at preventing excessive leverage as well as mitigating concentration and default risk. The 2019 Framework clarifies that SFTs "that would be included in the scope of the framework of numerical haircut floors include reverse repos, securities borrowing as well as margin lending", where "[m]argin lending transactions entail the provision of collateralised loans by a financial institution (usually a bank or a broker) to clients who are seeking leverage of their trading positions by borrowing money".

FSB recommended haircut floors

Numerical haircut floors for securities-against-cash transactions		
	Haircut Level	
Residual maturity of collateral	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 (including fund shares) within the scope of the FSB framework	10%	

Impact for investment funds

The application of haircut floors could result in a greater cost of funding, thus impacting market appetite for such activities and reducing market competitiveness. Numerous stakeholders requested that the FSB specifically exclude regulated investment funds from the 2019 Framework, including on the basis that they generally engage in SFTs for efficient portfolio management purposes rather than refinancing and the generation of leverage.

However, no exemption has been given and funds that engage in SFTs are in scope of the 2019 Framework and the above haircut floors. In July 2019, the deadline for implementation of the haircuts by regulatory authorities was extended to January 2024. The European Commission has stated that it will await receipt of the data which market participants are required to report under the Securities Financing Transactions Reporting (**SFTR**) Regulation before determining the manner in which the haircuts are implemented. Reporting under the SFTR for investment funds commences in October 2020.

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