Opinion of the European Economic and Social Committee on the 'Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions'

COM(2014) 40 final — 2014/0017 (COD)

(2014/C 451/09)

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On 25 February and 27 March 2014 respectively, the European Parliament and the Council decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the:

Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions.

COM(2014) 40 final — 2014/0017 (COD).

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 23 June 2014.

At its 500th plenary session, held on 9 and 10 July 2014 (meeting of 9 June), the European Economic and Social Committee adopted the following opinion by 183 votes, with 3 abstentions.

1. **Conclusions and recommendations**

1.1 The EESC **welcomes** the proposal for a regulation presented by the Commission, which is intended, in combination with the very closely related draft regulation on banking reform, to constitute a package of measures to make the European financial system more transparent and resilient where securities financing transactions (SFTs) are concerned.

1.2 It is in the eminent interest of the market and the economy as a whole to have more even information coverage across the entire market, to monitor the risk of ongoing operations and to reduce the scope for non-transparent and unregulated banking operations.

1.3 On this last point, the EESC finds the phrase 'shadow banking' misleading and a source of needless misunderstanding among the general public. It is **certain banking operations** that banks and non-banking entities perform that are 'shadowy' and not the banks themselves — or, to be more precise, financial institutions, since the operators in this particular market are often not actually banks. They include hedge funds, sovereign funds and finance companies specialising in money market funds or in structured and complex derivatives. All these operators are known; what the State does not know is some of their unregulated operations.

1.4 The EESC stresses the importance of this regulation, which serves to **bring market movements and pockets of excess risk out into the open**. These help market supervisory authorities to constantly monitor the situation and intervene pre-emptively to rein in activities generally deemed to be unduly risky. On the one hand, the regulation thus provides the market with information not available to the State and, on the other, gives the authorities an additional analysis and information tool.

1.5 Equally important is **regulation of rehypothecation** — the temporary use of securities entrusted to the operator. The requirement to obtain the explicit consent of investors owning the securities enables these investors to spurn taking on unforeseen risks which are not made clear in the contract. Counterparty risk becomes part and parcel of evaluation in a way that eliminates, or at least greatly hampers, operators who are not conspicuously trustworthy. All of this contributes to the overall resilience of the system in general and of businesses with a bigger market presence.

1.6 Given all the Commission's initiatives to return the financial system to its natural role as a driver of the economy and of household and business prosperity, the EESC believes that now is the time to launch a major **'social pact for sustainable finance'** in which all interested parties would be involved in redefining goals and instruments. The plummeting reputation of the banks, manifest in innumerable polls and probes over the last few years, should encourage all those involved to turn over a new leaf once and for all and hold themselves accountable to society. Households, businesses, citizens, workers and society in general are all calling for an efficient and reliable financial system that contributes to development and jobs and is highly attentive to the social and environmental impact of investments.

1.7 The EESC acknowledges the Commission's strong commitment in fulfilling its promises to present the 48 measures in the work programme of the new regulation. There is no doubt that the Directorate-General for the Internal Market has put in a great deal of outstanding work in very difficult circumstances. The guiding principles have been balance and efficacy. The EESC readily acknowledges this as one of the Commission's success stories, appreciating in particular its admission of 'regulatory gaps, ineffective supervision, opaque markets and overly-complex products'.

1.8 The EEC believes that, when adopted, the regulation will greatly lessen the risk of regulatory arbitrage and it encourages the Commission to continue pursuing the goal of **minimising unregulated operations in what are the peripheries** of Europe's financial system.

2. **The Commission proposal**

2.1 The proposal aims to improve the transparency of SFTs in three ways in particular:

— monitoring systemic risks linked to SFTs: the proposed regulation requires all SFT operations to be reported to a central database. This would enable inspection authorities to better identify links between banks and shadow banking operators, thereby casting light on some of the latter's fund-raising operations;

— providing information to investors whose assets are being used in SFTs: under the proposal, SFT operations performed by investment funds and other equivalent financing structures must be described in detailed reports. This would improve transparency for investors, who can then take more informed decisions;

— rehypothecation: the regulation seeks to improve the transparency of rehypothecation of financial instruments (any pre-default use of collateral by the collateral taker for their own purposes) 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 about the risks the operation might entail.

3. **Introduction**

3.1 As well as the proposal for structural reform of the EU's banking sector, the Commission has also proposed consolidating measures intended to boost transparency of SFTs and prevent banks sidestepping some of the rules by shifting such activity to the shadow banking sector. This is one of the Commission's main concerns.

3.2 SFTs cover a variety of transactions that have similar economic effects. Prime among these are securities lending and repurchase agreements (repos).

3.3 Securities lending is primarily driven by market demand for specific securities and is used, for instance, for short selling or settlement purposes. 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.

3.4 SFTs are used by fund managers to earn additional returns or to secure additional funding. For example, repo transactions are often used to raise cash for additional investments. At the same time, however, these operations can create new risks, such as counterparty risk and liquidity risks. Generally, only a part of the additional earnings is attributed to the fund, but the entire counterparty risk is borne by the fund's investors. Therefore, the use of SFTs may lead to a significant alteration of the fund's risk-reward profile.

3.5 The link between this package of measures and the proposal on structural reform of the European banking sector is clear. The latter would ban or put constraints on certain activities of banks. However, its desired impact could be diminished if these activities migrate from regulated banking groups towards the shadow banking sector, where there is less scope for monitoring by supervisors.

3.6 The Financial Stability Board (FSB) has highlighted the fact that the disorderly failure of shadow banking entities can carry systemic risk, both directly and through their interconnectedness with the regular banking system.

3.7 The FSB has also suggested that unduly stringent banking regulation could shove some banking activity into the shadow banking system ([1]).

4. **General comments**

4.1 The EESC welcomes the proposal for a regulation on transparency and reporting requirements for SFTs, which, in combination with the regulation on structural reform of the banking system, seeks to increase the resilience of the banking system, the transparency of operations and the resolution of potential crises without being an additional burden on the public.

4.2 This EESC opinion is closely linked, therefore, to the Committee's opinion on the structural reform regulation.

4.3 The EESC appreciates the Commission's admission regarding 'important regulatory gaps, ineffective supervision, opaque markets and overly-complex products' before the crisis erupted. These are arguments the EESC has been using since the financial crisis began in calling for urgent intervention measures. However, the Commission failed to heed carefully enough the warnings and recommendations that could have forestalled subsequent problems.

4.4 The EESC realises that economic forces, aggressive lobbies and the enormous stakes involved sought to avoid or delay necessary and urgent measures once the crisis had begun. Despite everything, and with the exception of a few decisions that cannot be endorsed, the EESC acknowledges that the Commission has implemented a whole set of measures announced following the release of the reports of the Larosière group and the Liikanen High-level Expert Group.

4.5 The EESC readily commends Commissioner Barnier for having abided by his undertakings and the entire Directorate-General for the Internal Market (which was responsible for the proposals on financial regulation) for its generally excellent work and for having delivered a raft of coherent and closely interlocking measures constituting a body of law marked by exceptional quality and undeniable efficacy. The cumulative effect of the legislative initiatives will be to progressively eliminate the causes behind the financial crises of the last few years.

4.6 The EESC has always espoused the need to have a well-functioning financial system geared to sustaining the real economy (particularly SMEs), to strengthening the social economy and to creating jobs. The credit industry has a crucial role to play in providing a service to society, making itself once again the engine and driver of the real economy in full awareness of the social responsibility it needs to deliver.

4.7 The EESC thinks that a radical change in the relationship between financial institutions and the public can no longer be deferred. The nose-dive in confidence in banks and other entities must be halted, since it could inflict irreparable damage on economic and social development.

4.8 In line with many of its previously expressed views on civil society involvement, the EESC would like to see a **'social pact for sustainable finance'** drawn up in Europe in which all interested parties would participate in framing an efficient, resilient and transparent financial system alert to the environmental and social impacts of its actions.

4.9 The EESC wholeheartedly supports the Commission's initiatives to avoid — on the one hand — the risk of regulatory arbitrage and — on the other — a flight of business towards a barely regulated area such as that of shadow operations, where the increasingly tight rules that are being promulgated are avoided.

4.10 The EESC has stated its own position clearly in its opinions on this matter ([2]), namely that unregulated areas in the financial sector should be minimised.

([1]) OJ C 170, 5.6.2014, p. 55.
([2]) OJ C 177, 11.6.2014, p. 42; OJ C 170, 5.6.2014, p. 55; and the opinion on Structural reform of EU banks (ongoing).

4.11 In drafting the proposal for a regulation, the Commission has taken on board the need to minimise additional costs for the financial system, seeing possible solutions in infrastructure such as repositories and in existing procedures to achieve transparency in derivatives transactions laid down in Regulation 648/2012. The EESC endorses this approach, which shows the consideration the Commission has extended to operators and end clients, who could most likely have to bear the extra costs entailed in this regulation.

4.12 The EESC contends that financial stability deriving from greater transparency on the activities covered by the regulation, such as securities financing operations, equivalent financing structures and rehypothecation, would be effectively increased, thus boosting the overall resilience of the system and individual operators. The inclusion of all the counterparties operating in the financial markets guarantees comprehensive information about the real nature of transactions and the risk profiles that individual operators take on.

4.13 For these reasons, the present regulation is essential to perfect the effectiveness of the regulation to reform the structure of the banking system, which deals with banking undertakings big enough to be considered as potentially embodying a systemic risk. It also reduces the scope for opting for transfer to non-regulated areas of the financial system.

5. **Specific comments**

5.1 The proposal aims to improve the transparency of SFTs, in three ways in particular:

5.1.1 Monitoring systemic risks linked to SFTs: the proposed regulation requires all SFT operations to be reported to a central database. This would enable inspection authorities to better identify links between banks and what are generally termed 'shadow' banking operators, thereby casting light on some of the latter's fund-raising operations.

5.1.1.1 In the EESC's view, this approach would help supervisors to monitor the exposures to — and risks associated with — SFTs and, if necessary, take better-targeted and timelier action.

5.1.1.2 The EESC wonders whether the proposal to retain data in the register repositories for at least ten years is really appropriate. The EMIR regulation, for example, only requires five years.

5.1.2 Providing information to investors whose assets are being used in SFTs: the logic of the proposal is that there is room to improve transparency for investors about the practices of investment funds involved in SFTs and other equivalent financing structures by requiring detailed reporting on these operations. This would lead to better-informed investment decisions by investors.

5.1.3 Rehypothecation: the regulation seeks to improve the transparency of 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 mean that clients or counterparties gave their consent before rehypothecation could take place. They would also make that decision based on clear information on the risks that it might entail.

5.1.3.1 Since the Lehman collapse in 2008, transparency and the promotion of a 'data culture' have become the order of the day on the financial markets. The EESC entirely endorses this trend and fully supports the transparency enshrined in the mechanism proposed and the involvement of the investor through explicit consent to be given for each operation.

5.2 Financial markets are global and so the systemic risks created by shadow banking entities must be tackled in a coordinated way at international level. The EESC believes it is indispensable to strengthen cooperation with the authorities in the third countries most concerned in order to agree on a joint strategy and coherent and, if possible, equivalent measures.

5.3 The EESC thinks that the proposal is consistent with the Recommendations of the Financial Stability Board. In August 2013, the FSB adopted eleven recommendations for tackling risks inherent in securities lending and repurchase agreements. The proposed regulation is in line with four of these recommendations (Nos 1, 2, 5 and 7) related to the transparency of the securities financing markets, disclosure to investors and rehypothecation.

5.4 The EESC does not consider the administrative burden this regulation imposes on the financial system to be excessive, but it does compound other administrative and management red tape imposed by other regulation. The EESC stresses the risk that it will be households and businesses who bear this burden. This will either make the financial system more onerous for users or cut bank profits, which is undesirable given the already difficult situation in which the European credit system currently finds itself.

5.5 The EESC stresses the importance of including UCITS (undertakings for collective investments in transferable securities) and AIFMs (managers of alternative investment funds) in the communications obligations in relation to their reports, as laid down in Directive 2009/65/EC, which recasts legislation in force, and in Directive 2011/61/EC.

5.6 Another very important point concerns the sanctioning regime, which, as well as being effective, proportionate and dissuasive, must include a series of minimum measures. The Member States have the option of imposing stiffer administrative sanctions as well as introducing criminal sanctions in particularly serious cases. In this event, they must ensure information is exchanged between national authorities, the ESMA (European Securities Markets Authority) and the Commission.

5.7 As with the EMIR regulation, the EESC notes that Article 24, on publication of decisions on the imposition of administrative sanctions, leaves too much discretion to the competent authorities, who could draw different conclusions about the same case, all the more so if they are from different countries. What concrete evaluation could be made as regards possible jeopardy to the stability of the financial markets?

5.8 The EESC thinks it important for the principle of equivalence to be included in the proposal, in keeping with Article 13 of the EMIR, and asks the Commission to effect this.

5.9 While appreciating that the delegated acts envisaged in this regulation are limited in scope and are appropriate, the EESC is concerned that no time is set for the exercise of this delegation. The EESC points out that it has already expressed its reservations on this matter on numerous occasions.

5.10 The EESC endorses Article 15 in its entirety, but notes the risk of possible disputes between counterparties regarding the efficacy and equivalence of a system other than signature and suggests that at least some examples be given of these equivalent alternative mechanisms, for example registration by telephone or electronic certification.

Brussels, 9 July 2014.

The President
of the European Economic and Social Committee
Henri MALOSSE