

**The LIAJ's Comments on the FSB's
Consultative Document
Strengthening Oversight and Regulation of
Shadow Banking
A Policy Framework for Addressing Shadow Banking
Risks in Securities Lending and Repos**

11 January 2013

The Life Insurance Association of Japan (LIAJ)

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1. General opinions on the consultative document

1. We, the Life Insurance Association of Japan (LIAJ), would like to extend our gratitude to the Financial Stability Board (FSB) for providing us with the opportunity to submit our comments on the consultative document *A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, which was published in 18 November 2012.
2. The LIAJ is a trade association comprised of all 43 life insurance companies operating in Japan. Its aim is to promote the sound development of the life insurance industry and maintain its reliability within Japan. We would like to respectfully request that the FSB carefully consider comments submitted by the sole representative body of the life insurance industry in Japan, the second largest life insurance market in the world.
3. We have deep concerns about, in particular, the proposed 'minimum standards for cash collateral reinvestment' and 'standards for minimum haircuts', presented in the consultative document. Therefore, we would like the FSB to take into account the differences in circumstances and business profile in each jurisdiction and avoid adopting uniform regulation.
4. Considering the nature of cash-collateral repo transactions by life insurers in Japan described below, we think the proposed 'minimum standards for cash collateral reinvestment' focus essentially on market participants who are engaged in security lending by using 'client assets' managed separately from their own assets (e.g. custodians), rather than life insurers who are engaged in security lending as their own account.
5. Life insurers in Japan manage and invest premiums received from their policyholders in exchange for insurance cover as their proprietary assets (own assets) in order to fulfil their obligation to pay future insurance and pension benefits, and as part of their management and investment, they are engaged in securities lending and repos by using some part of large-sized security portfolio they hold. Thus, we think that life insurers in Japan would not need to make strict matching, as they manage cash flows taking into account not only positions occurred by securities lending and repos, but also cash flows as a whole including those positions.
6. Furthermore, life insurers in Japan can not identify reinvestment portfolio, as they invest received cash collateral collectively with premiums received and cashes for future claims given their objective of improving efficient asset management.
7. In addition, liquidity problems occurred in the financial crisis motivated to propose regulation in this consultative document, we believe that life insurers in Japan as well as banks should be excluded from the standards, as insurers in Japan are sufficiently supervised and monitored by regulatory authorities with regards to the liquidity risk management.
8. Besides, in terms of types of contracts, we think that the standards for cash collateral reinvestment need not be applied for closed-end contracts as these contracts set out due date for return, and calls for the return are foreseeable unlike the open-end contracts that can be recalled at any time.
9. With regards to the proposed 'standards for minimum haircuts', we believe that particularly transactions posting sovereign bond (e.g. Japanese Government Bond) as collateral in Japanese market should be excluded from the standards, considering the circumstance that the haircut is not applied in the current market practice, as well as the high liquidity of the bonds.

10. In essential, setting numerical floors of the haircut at relatively high level would lead to, for example in repos, delivering much more sovereign bonds as collateral and thus, institutional investors may have concerns about the lost investment opportunity from restrictions on flexible trading of sovereign bonds and the decline in the liquidity of the market. Furthermore, we think that the level of the haircut, particularly for domestic transaction in each jurisdiction, should be the level that align with market practice in that jurisdiction, as there may be a concern that securities firms with relatively poor collateral reserve will incur increased transaction cost when it is necessary for those firms to secure additional collateral.

2. Responses to the questions

Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items.

11. As we stated in the above general opinions, life insurers in Japan can not identify reinvestment portfolio, as they invest received cash collateral collectively with premiums received and cashes for future claims given the objective of improving efficient asset management. Therefore, we think that life insurers in Japan will not be able to report data 'related to cash collateral reinvestment'.
12. Moreover, even if life insurers in Japan are required to submit data related to cash collateral reinvestment, we believe that due consideration should be given when requiring disclosure of submitted data so as not to lead to disclosure of each firm's cash management policy and investment behaviour.

Q12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?

13. In Japanese market, the haircut is not currently applied on the sovereign bond collateral. Therefore, if the haircut is actually applied on the collateral, we have deep concerns that not only the life insurance industry in Japan but also all market participants might incur practical burden such as the need to develop system infrastructure and put in place back-office infrastructure.

Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

14. In our view, as for transaction using sovereign bond as collateral, particularly those issued by the government within its own jurisdiction (such as Japanese government Bond issued in Japanese market), those transactions should be excluded from the scope of 'standards for minimum haircuts', considering the high liquidity of the bonds.
15. In essential, setting numerical floors of the haircut at relatively high level would lead to, for example in repos, delivering much more sovereign bonds as collateral and thus, institutional investors may have concerns about the lost investment opportunity from restrictions on flexible trading of sovereign bonds and the decline in the liquidity of the market. Furthermore, we think that the level of the haircut, particularly for domestic transaction in each jurisdiction, should be the level that align with market practice in that jurisdiction, as there may be a concern that securities firms with relatively poor collateral reserve will incur increased transaction cost when it is necessary for those firms to secure additional collateral.

Q14. Are there additional factors that should be considered in setting numerical haircut floors as set out in section 3.1.3?

16. We believe that debt securities with high liquidity next to sovereign bonds such as local government bonds, agencies securities and government guaranteed securities should be addressed as additional factors.

Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

17. In our view, especially in the case of Japan, transactions conducted within the firm's own jurisdiction using the sovereign bonds of that jurisdiction as collateral should be excluded from the scope of application of the framework considering the high liquidity of the bonds.
18. Besides, with regards to (i) transaction type, we think that there would be a concern that negative impact of strict regulation on the general collateral (GC) repos of sovereign bonds, for example, may also spread widely into short-term financial market, since they are used as one of the main operations for financing conducted by Japanese central bank.

Q19. Do you agree with the proposed minimum standards for the reinvestment of cash collateral by securities lenders, given the policy objective of limiting the liquidity and leverage risks? Are there any important considerations that the FSB should take into account?

19. We do not agree with the proposed minimum standards for the reinvestment of cash collateral. Considering the nature of cash-collateral repo transactions by life insurers in Japan described below, we think the proposed 'minimum standards for cash collateral reinvestment' focus essentially on market participants who are engaged in security lending by using 'client assets' managed separately from their own assets (e.g. custodians), rather than life insurers who are engaged in security lending as their own account.
20. Life insurers in Japan manage and invest premiums received from their policyholders in exchange for insurance cover as their proprietary assets (own assets) in order to fulfil their obligation to pay future insurance and pension benefits, and as part of their management and investment, they are engaged in securities lending and repos by using some part of large-sized security portfolio they hold. Thus, we think that life insurers in Japan would not need to make strict matching, as they manage cash flows taking into account not only positions occurred by securities lending and repos, but also cash flows as a whole including those positions.
21. Furthermore, life insurers in Japan can not identify reinvestment portfolio, as they invest received cash collateral collectively with premiums received and cashes for future claims given their objective of improving efficient asset management.
22. In addition, liquidity problems occurred in the financial crisis motivated to propose regulation in this consultative document, we believe that life insurers in Japan as well as banks should be excluded from the standards, as insurers in Japan are sufficiently supervised and monitored by regulatory authorities with regards to the liquidity risk management.
23. Besides, in terms of types of contracts, we think that the standards for cash collateral reinvestment need not be applied for closed-end contracts as these contracts set out due date for return, and calls for the return are foreseeable unlike the open-end contracts that can be recalled at any time.