European Fund and Asset Management Association

EFAMA's response to the FSB's consultation on the proposed application of numerical haircut floors to non-bank-to-non-bank transactions

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 63 corporate members almost EUR 17 trillion in assets under management of which EUR 10.6 trillion managed by 55,000 investment funds at end June 2014. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org

Preliminary Remarks

EFAMA appreciates the opportunity to reply to this additional FSB consultation around the application of minimum haircut floors to securities financing transactions (SFTs). Below are a few preliminary remarks we are keen to point out, before addressing each of the individual questions further below:

- In line with our earlier reply to the previous FSB consultation around a Policy framework for addressing shadow banking risks in securities lending and repos in November 2013, we wish to strongly re-iterate the fact that regulatory concerns around pro-cyclicality and leverage resulting from repo and securities lending transactions are better tackled directly – i.e. where specific legislation (such as the UCITS and AIFM frameworks in the EU) is expressly aimed at capping excessive exposures via clear leverage, counterparty and issuer limits, via portfolio diversification requirements, as well as via high level guidelines on collateral quality that are key to securing those that are commonly termed as "securities financing transactions" (SFT). In the EU, such operations in the investment management context go under the name of "efficient portfolio management" (EPM) techniques and aim solely at improving the relative performance of investment funds instead of financing portfolio positions that would create the sort of intermediation risks the FSB has exposed under its broad mandate on shadow banking. More relevant details of the applicable EU rules in this respect are presented and clarified in our answers further below;

- In our 2013 reply, we also presented a clear case for European investment funds, particularly those subject to the EU UCITS Directive[1] regime, to be considered as "regulated intermediaries" under the FSB's overarching policy framework, as published on 29 August 2013. To the extent that the FSB classifies investment funds as "non-banks", we would argue

[1] Please refer to the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive – 2009/65/EU – as recently amended, available at:
http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&from=EN

against the FSB's proposition of a numerical haircut floor framework with the main reason being that its scope would cover an extremely large range of very different market players within one or more jurisdictions, each subject to diverging regulatory requirements, even within the sole investment management industry;

- Furthermore, although not prudentially regulated in light of the very different "agency" business model that asset managers run on a daily basis if compared to the banking industry, the existing rules imposed on the European investment management industry, as well as the hard constraints for all investment managers to prudently manage and match their assets with their liabilities, are in our view a largely sufficient incentive to avoid the build-up of significant maturity and liquidity mismatches, as well as leverage. More specifically, EFAMA and its Members wish to point out that, apart from their fiduciary duties *vis-à-vis* investors, investment managers further count on rigorous (both regulatory and internal) criteria for the selection of their SFT counterparties, as well as on equally rigorous requirements governing collateral quality. In our view, these safeguards are largely sufficient to prevent the risks identified by the FSB from materialising and where a minimum haircut floor framework would complement only marginally;

- The FSB should also recognise that the largest part of the investment management industry is a net lender of securities, where these are exchanged for either cash or non-cash collateral in the context of non-centrally cleared SFTs. To the extent that specific regulatory requirements limit the re-investment of cash collateral only – such as the collateral requirement applying to UCITS funds under ESMA's recent *Guidelines on ETFs and other UCITS issues* – we would argue that these types of registered vehicles do not "obtain financing against collateral" in the sense defined in the FSB's Policy framework and should therefore be out of scope. On this basis, we would decisively also contest any proposal – as that under the product-based or market regulation approach - that would oblige the already-authorised investment managers be subject to additional "registration and reporting requirements to allow authorities to monitor compliance". Such is already the case in virtually all FSB jurisdictions where investment management companies advise and manage assets on behalf of third party clients, particularly in Europe where the UCITS and AIFM Directive requirements currently apply across 28 jurisdictions;

- By introducing minimum haircuts for securities lending and repo transactions, recalling our earlier reply, EFAMA fears that these may lead to the unintended consequence of becoming the *de facto* norm for those markets. Regardless of whether the proposed framework is introduced and applies to non-bank entities other than investment funds for the reasons explained in our replies below, haircut floors – if any – should be set at conservative "backstop" levels, i.e. below the prudent market standards for actual haircuts in benign market conditions. In this regard, we welcome the fact that the FSB has stressed the incentive for non-bank market participants to maintain their own, more granular and dynamic risk assessment methods for the purpose of calculating their own haircut schedules, regardless of whether or not the proposed framework will apply.

Consequently, we see a clear case for the differential treatment of non-bank entities based on the proportionality principle and according to their true systemic risk potential on the basis of existing regulatory requirements. In particular, we believe that FSB Member jurisdictions should be able to exempt certain market players or certain activities from the requirement to apply the proposed numerical haircut floors where the stability risks associated with their engagement in SFTs are absent or essentially mitigated by the relevant national / supranational regulatory framework. In the EU context, such treatment should be granted for the above proportionality considerations to UCITS and other investment funds complying with the same UCITS standards on securities lending and repos, collectively going under the more appropriate name of "efficient portfolio management" (EPM) techniques.

Responses

Q1. Do you agree that the application of the framework of numerical haircut floors as described in Section 3.3 to non-bank-to-non-bank transactions will help to reduce the risk of regulatory arbitrage and would maintain a level playing field?

In general, the large majority of transactions involving investment funds as counterparties (whether UCITS / mutual fund-like structures, or alternative / private fund investments) are carried out vis-à-vis "regulated entities", i.e. large banks and broker-dealers, and therefore funds should be out of the scope of the envisaged FSB framework with a focus on non-bank-to-non-bank transactions. Furthermore, it is a wide-spread market practice among EFAMA's Members to over-collateralise their SFT exposures as an additional safe-guard.

Where the envisaged framework of numerical haircut floors – as defined in Section 3.3 - is intended to apply to transactions where the primary motive is to provide financing, rather than to borrow or lend specific securities, EFAMA would observe that the majority of investment management activities with recourse to SFTs are out of scope. Moreover, the large portion of European investment vehicles that fall under the UCITS regulatory regime have strict cash collateral re-investment requirements in place, bringing these funds out of scope, given that their securities are lent at call and that they may only re-invest received cash collateral into high-quality government bonds (i.e. and thus outside the scope of the FSB proposed framework in any event), use it in reverse-repo transactions with credit institutions (i.e. "regulated entities" in the FSB's wording and thus subject to prudential requirements) or invested it at short maturities in short-term MMFs. In this regard, we would encourage the FSB to refer to the detailed collateral re-investment requirements applicable to UCITS funds under ESMA's recent *Guidelines on ETFs and other UCITS issues*, where these incorporate all (and more) of those minimum standards for the reinvestment of cash collateral by securities lenders, as indicated under Section 3.1 of the FSB August 2013 Report.[2] On their part, the same transactions that are collateralised with

[2] In this regard, please refer to paragraph 43, letters i) and j) of the Guidelines. Moreover, under paragraph 44, such re-invested cash collateral shall be diversified in accordance with the diversification requirements also

securities (i.e. non-cash collateral), may not be re-sold, re-invested or pledged, thereby avoiding the related risks altogether.

With regard to investment vehicles that are non-UCITS funds, i.e. a very broad range of alternative investment fund (AIF) vehicles caught under the EU AIFM regime, these funds are generally less constrained in terms of recourse to SFTs (or more appropriately, EPMs as explained above), although are still subject to ongoing monitoring by - and to stringent reporting requirements to - market supervisors (in particular, when they are recognised as employing leverage "on a substantial basis", i.e. with a leverage factor above 3:1). Mandatory reporting to market supervisors for EU AIFs includes information about the overall level of leverage employed by each fund, a break-down between leverage arising from borrowing of cash or securities and leverage embedded in financial derivatives, and the extent to which the fund's assets have been reused under leveraging arrangements. Moreover, it should be noted that many EU Member States have extended the UCITS standards for SFTs to some or all AIFs domiciled in their jurisdictions.

Q2. In your view, how significant is the current level of non-bank-to-non-bank transactions? Do you expect that level to increase going forward and why? What types of non-bank entities are, or could be, involved in such transactions?

As a first point, EFAMA would like to point out that non-bank entities – and investment funds in particular – that engage in SFTs usually transact with prudentially regulated bank entities which are out of the scope of this consultation. A more granular view able to effectively monitor flows between non-banks is at the current stage not possible as a result of the data gaps that the FSB has correctly identified and is actively tackling. EFAMA is aware of and supports the important work carried out by the FSB's work-stream 3 (WS3) in this regard, with the objectives to identify five key shadow banking activities, to outline an overarching policy framework and regulatory "tool-kits" to contain specific risks, and to ensure an adequate exchange of information between supervisors on the types of non-bank entities that perform any of the five activities in their own specific jurisdiction.[3]

As a general statement, EFAMA would agree that non-bank-to-non-bank transactions in overall size are increasing. A very rough proxy of such trend could be the findings of the FSB's recent 2014 Global Shadow Banking Monitoring Report reflecting the growth trends in non-bank financial intermediation across jurisdictions, although such intermediation to a large extent also captures bank entities.[4]

applying to non-cash collateral. For further references, please see the relevant ESMA Guidelines (as amended in August 2014) , available at: http://www.esma.europa.eu/system/files/esma-2014-0011-01-00_en_0.pdf

[3] Please refer to the FSB *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* published on 29 August, 2013; available at: http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

[4] According to the Report, as measured by total financial assets held by Other Financial Intermediaries (OFIs) and bearing in mind all the data limitations highlighted in the Report, OFIs include all non-bank financial intermediaries with the exception of insurance companies, pension funds and public financial institutions. The universe of OFIs was then sub-divided into 8 sub-sectors, i.e. Money Market Funds, Finance Companies,

Q3. Do the approaches set out above cover all potential approaches in applying numerical haircut floors to non-bank-to-non-bank transactions? Are there any other approaches? If so, please describe.

Besides the three approaches described under Annex 4 of the Report, we do not see additional ones that could be applied. We would insist that, notwithstanding the chosen approach, the FSB and domestic supervisory authorities that are to implement the proposed framework guard a sufficient degree of flexibility by exempting certain "non-bank financing models that do not pose financial stability risks" from the proposed framework. Among these, we first and foremost wish to cite the EU regulatory regime applicable to UCITS funds for the reasons expressed above.

Out of the three approaches, we would favour the third, i.e. the hybrid one that blends product-based (or market) with entity-based regulation. Despite the few drawbacks as highlighted in the consultation report, it would allow market supervisors sufficient flexibility depending first and foremost on whether the relevant non-bank actors are regulated - and if yes, to what degree - in their relative jurisdiction. Endowing market supervisors or even portfolio managers with sufficient flexibility is also important in the light of existing legislation in certain jurisdictions. For instance, within the EU, ESMA's aforementioned UCITS-specific Guidelines foresee that, for collateral that is received in the context of an SFT (or more appropriately, an EPM) transaction, the fund manager should have in place a clear haircut policy adapted for each asset class of received collateral. When designing such policy, the manager should take into account the characteristics of the assets such as their credit quality or price volatility, as well as the outcome of the stress tests it is required to perform (these tests also consider haircuts as tools to mitigate investment losses as simulated). Finally, this policy is to be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets as received. These requirements also extend to collateral received where the fund is a counterparty to an OTC derivative transaction.[5]

In the EU, the hybrid approach is already being put into regulatory practice with entity-based standards for securities lending/repos applicable to certain market participants such as UCITS and pending discussions on market-wide treatment under the proposed EU Regulation for SFTs.

Structured Finance Vehicles, Hedge Funds, Other Investment Funds, Broker-Dealers, Real-Estate Investment Trusts and Funds. Across 20 FSB jurisdictions and the Euro Area (20+EA), the report recorded a 7% increase in total OFI assets worldwide in the period 2012 - 2013. Of these, the fastest growing sub-sector was that of "Other Investment Funds", with assets in excess of US$ 24 trillion and capturing equity, fixed income and other investment funds, with the exception of MMFs and hedge funds. Such strong growth, well above its 2007-12 average growth rate, may be partly explained by the valuation effects amid rising asset prices in 2013 and partly as a result of these funds' increased importance in the current financial market landscape. The Report is available at: http://www.financialstabilityboard.org/wp-content/uploads/r_141030.pdf

[5] For further information, see paragraphs 45 and 46 of the ESMA *Guidelines* referenced above.

Q4. Please provide any comments you have on the strengths and weaknesses of the approaches set out above, as well as any other approaches you believe the FSB should consider. What issues do you see affecting the effective implementation of numerical haircut floors for non-bank-to-non-bank transactions?

The relative strengths and weaknesses of the different approaches are succinctly and sufficiently exposed in Annex 4 of the Report. The main problem for the effective implementation of numerical haircut floors for non-bank-to-non-bank transactions – where these are introduced – is that different entities may be regulated differently (also depending on their size and on their relative importance as intermediaries of credit) and may not present the same types of risks as a result of existing and mutually reinforcing safe-guards. Where this is the case, the additional imposition of a haircut framework that is not already required under existing regulation would appear in our view superfluous. Please also refer to our answer above.

Q5. What forms of avoidance of the numerical haircut floors are most likely be employed for non-bank-to-non-bank transactions? Which of the proposed implementation approaches is likely to be most effective in preventing such avoidance?

As a first step, EFAMA would suggest the FSB to consider whether any of the non-bank entities mentioned in the consultation are in fact regulated at all. A registration with the domestic financial markets supervisor, combined with regular reporting lines that would suggest the materialisation of liquidity / maturity mismatches or leverage on any scale, would necessarily be the starting point for the eventual further imposition of a haircut framework. For well-regulated industries, like that of investment management and for the reasons discussed in the introductory remarks above, numerical haircuts represent an additional “line of defence” behind other more important risk mitigating / management measures aimed at ascertaining the proper credit quality of an SFT counterparty, as well as the quality of the received / posted collateral. We are also not familiar with any form of deliberate avoidance of numerical haircut floors in jurisdictions where these already apply.

Q6. If different entity-type regulations are used, do you see the need to ensure comparative incentives across different entity types? If so, please describe any potential mechanisms that may help ensure comparative incentives across entity types?

As per our response to Question 3 above, we would favour the third approach, i.e. the hybrid one, where the concern of ensuring comparable incentives does not arise.

Q7. If market regulation is used, should the FSB consider setting a materiality threshold of activity below which entities do not need to register? If so, what could be an appropriate level for such a threshold?

In theory, EFAMA could support the idea of a threshold that would trigger the application of the proposed framework. Such a threshold could be based on a pre-agreed total leverage factor, high enough to exempt all non-bank actors already subject to leverage limits. For instance, in the EU investment management space, such a threshold could be applied to alternative investment funds (AIFs) that "employ leverage on a substantial basis" above a factor of 3:1, as calculated using the commitment approach. Leverage should in this case be calculated at the sub-fund compartment level, using the appropriate LEI reference.

Q8. Do you see the need for a phase-in period in applying numerical haircut floors to nonbank-to-non-bank transactions, and if so how long should it be and why? Does the appropriate phase-in period vary depending on which approach is followed? Should it vary by jurisdiction based on the size and importance of the non-bank-to-non bank sector or should it be consistent across jurisdictions?

EFAMA's view, as well as that of our numerous Members, is that when such profound and far-reaching changes are agreed upon and need to be implemented – e.g. as in the case of the European Markets Infrastructure Regulation (EMIR) in Europe concerning the regulation of OTC derivatives, central counterparties and trade repositories – we would caution that a possible phase-in period should in principle be no shorter than two years and closely calibrated with analogous requirements for collateral risk management the derivatives space.

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