Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

Email: fsb@bis.org

15 December 2014

Re: FSB Consultation Document: Strengthening oversight and regulation of shadow banking: Regulatory framework for haircuts on non-centrally cleared securities financing transactions

Dear Sirs and Madams,

The Global Financial Markets Association ("**GFMA**")[1] appreciates the opportunity to comment on the paper and consultation issued in October 2014 by the Financial Stability Board ("**the FSB**") entitled "*Regulatory framework for haircuts on non-centrally cleared securities financing transactions* ("**the Paper**"). We note that our response and comments include the views of the SIFMA Asset Management Group.[2]

The dialogue and the formal consultation with the industry as this important framework was developed has led to an approach that addresses many of the concerns for overall financial stability related to the build-up of excessive leverage expressed by the FSB without being harmful to important market functioning.

The Paper describes the finalized regulatory framework for both the qualitative standards for methodologies used by market participants to calculate haircuts and the levels of numerical haircut floors for transactions within the scope of these limitations. The Paper also, in Annex 4, seeks public consultation on the application of the numerical haircut floors to non-bank to non-bank transactions. Our response is in two parts: first, we have collected a number of

[1] The Global Financial Markets Association brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit http://www.GFMA.org.

[2] The SIFMA Asset Management Group (AMG) actively participated in the composition of this letter. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

questions/requests for clarification on the finalized framework that we believe would benefit from further commentary from the FSB, perhaps in the form of Frequently Asked Questions, which we believe would be useful for ensuring consistency of implementation by local regulators. We believe that this response should be provided/developed as soon as practicable and, in any event, before the local regulatory authorities begin the process of implementing the recommendations. Second, we have responded to consultation questions in Annex 4.

I. Finalized regulatory framework for haircuts: areas for further clarification

As noted in the Paper, there are two complementary elements to the haircut framework:

(i) Qualitative standards to be incorporated into existing or new regulatory standards for methodologies used by market participants that provide securities financing to calculate haircuts on the collateral received;

(ii) A framework of numerical haircut floors that will apply to non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided to non-banks by banks and broker/dealers.

As this framework will need to be implemented by local regulatory authorities and the Paper notes that market participants are expected to establish appropriate internal processes and procedures to ensure that haircuts are set in accordance with the framework, we believe that the areas outlined below would benefit from additional clarity. GFMA recommends that these issues be addressed through publication of frequently asked questions. In addition, and consistent with G20 regulatory reform principles, we believe that the FSB should ensure the implementation of the framework by local authorities is undertaken in a coordinated and consistent manner.

Entities subject to capital and liquidity regulation

It would be helpful if the FSB would confirm that the reference to banks and broker/dealers subject to capital and liquidity regulation on a consolidated basis should apply to all entities within the relevant consolidated group.

"Non-bank"—Consistent local approaches

While GFMA does not believe it would be helpful for the FSB to provide a more detailed definition of "non-bank", we note that this is a significant concept throughout the framework. Although local authorities will naturally define the concept consistent with local jurisdictions' characteristics, we would urge the FSB to monitor implementation for broad consistency. GFMA further urges the FSB to take an active role in ensuring broad harmonization and cross-sector

consistency between banks and non-bank entities. We stress, however, that GFMA supports the FSB's activities-based approach to shadow banking, which avoids regulation that targets specific entities and creates market asymmetries.

Inter-affiliate transactions

Consistent with similar regulatory approaches, GFMA recommends that FSB make clear that the haircut regime does not include intra-group transactions. This approach would be similar to that taken under other regimes that regulate other products that pose similar overall risks as securities financing transactions.[3]

Scope of the qualitative methodology

Further clarity is needed as to the scope of the transactions covered by the qualitative standards in the haircut framework. Specifically, we note that the FSB's focus is on securities financing and, we believe, both the quantitative and qualitative standards should be limited to bona fide financing transactions. As the Paper notes in Section 3.1 with respect to the quantitative standards, the intent is to capture transactions where the primary motive is to provide financing rather than to borrow/lend specific securities. As the Paper notes in Section 3.3, some transactions that are commonly referred to as "securities financing transactions" are not entered into for financing purposes and we believe the FSB should indicate that these transactions would not be subject to the qualitative standards.

In order to identify the transactions that are not financing transactions and that should be excluded from the qualitative standards, we suggest that the FSB clarify by noting, consistent with the overall approach of the haircut framework and methodology, that transactions that meet either of the following criteria would be excluded:

(i) If the lender of securities receives cash collateral and that cash collateral is reinvested in accordance with the minimum standards proposed under Section 3.1 of the FSB's August 2013 policy recommendations[4]; or

(ii) If the borrower of the securities intends to use the received securities to meet a current or anticipated demand (delivery obligations, customer demand, meet segregation requirements etc.)

[3] See, for example, EMIR Article 11(7) in which certain intra-group transactions are exempt from requirements subject to conditions.
[4] FSB, *"Strengthening Oversight and Regulation of Shadow Banking Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repo"*, published 29 August 2013.

This clarification would ensure that transactions that are not undertaken for financing purposes would be outside the scope of the regime, provide the local regulators with an objective description of the intended scope and would not negatively impact the important transactions that provide access to specific securities and serve to enhance the efficiency of the market.

Interaction with capital regimes

Further clarity as to the interaction of the qualitative standards with banks' capital regimes is warranted. Specifically, if upon application of the qualitative requirements, a haircut is not applied, the bank should hold capital against that transaction pursuant to current prudential requirements. GFMA recommends that FSB clarify that firms have the flexibility to enter into transactions with a haircut level lower than the amount calculated based on the parameters within the qualitative standards and instead hold capital against this risk in accordance with appropriate regulatory capital requirements. It would be beneficial to clarify that that the qualitative standard should not, in effect, create a second, hard, haircut floor or supplant existing regulatory capital requirements.

Government securities

GFMA requests that the FSB provide further clarification on the definition of government securities. We note footnote 11 which provides some direction. However, explicit clarification as to the expected treatment of securities that are not direct obligations of the sovereign is important so that local regulators take a consistent approach. In particular, GFMA recommends that the FSB recognize that certain high-quality quasi-government securities, such as those issued by Fannie Mae, Freddie Mac and other comparable entities, be included within the definition in order to ensure that their use as collateral does not subject a transaction to the regime. Given the global nature of this market it is important to have consistent approaches across local authorities and we believe that this clarification would enhance consistency across jurisdictions.

Reliance on counterparty representations

A number of elements of the framework would require that determinations be made by the bank or broker/dealer with respect to facts that are largely in control of the counterparty. For example, in order to be excluded from the numerical haircuts, market participants must determine that a counterparty is subject to adequate capital and liquidity regulation on a consolidated basis. In addition, banks and broker/dealers may need to determine that a transaction is not a financing. Further clarity that, with respect to requirements for reliance on exclusion from the framework, market participants may rely on representations of their

counterparties would be helpful to market participants in developing their own internal processes and procedures to implement the framework.[5]

Numerical haircut floors levels

With respect to the quantitative levels, the FSB should confirm that certain securities backed by a pool of assets and a corporate obligation (such as covered bonds or U.S. agency MBS) should be treated as corporate bonds rather than as a securitization. Such instruments benefit from the ultimate obligation of a corporate entity and do not rely only on pools of assets for their credit quality, and thus, would more appropriately be treated as corporate obligations.

"Collateral upgrade" transactions

A clearer description of transactions exempted from the collateral upgrade transaction requirements would provide additional certainty to market participants. In particular, we believe that transactions in which the more liquid security of the exchanged securities cannot be further re-used by the collateral taker should be exempt as well as those transactions in which the security borrowed is borrowed in order to meet a current or anticipated demand (delivery obligation, customer demand, segregation requirements etc.) This construct would be consistent with the framework's overall approach to exempted transactions (i.e. not for financing) and would not increase financial instability through an overuse of leverage.

II. Annex 4: Proposed application of numerical floors to non-bank-to-non-bank transactions

We have noted the consultation questions from the Paper with our answers below.

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?

GFMA recommends that the quantitative standards should not be limited to financing provided from banks and brokers/dealers to non-banks. GFMA supports the extension of the framework of numerical floors to non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided between entities other than banks and broker/dealers. Expanding the framework is necessary to maintain a level-playing

[5] See, for example, *ESMA's Questions and Answers, Implementation of the Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), OTC Question 4* ("FCs are not expected to conduct verifications of the representations received from NFCs detailing their status and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect.") at http://www.esma.europa.eu/system/files/2014-1300_qa_xi_on_emir_implementation_october_2014.pdf.

field between banks and broker/dealers on the one hand and non-bank lenders on the other which would otherwise benefit from their status. The latter should be subject to same haircut floors and to equivalent type of regulation as the former.

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?

GFMA cannot comment on the size of non-bank-to-non-bank transactions. However, GFMA agrees with the FSB assessment that, for the time being, the volume of non-bank to non-bank transactions should be small enough so as not to represent a material threat to financial stability. Expanding the framework would avoid encouraging an otherwise inevitable shift of securities financing activity to non-bank to non-bank transactions. Therefore, it seems to us crucial not to focus on the current level of non-bank to non-bank transactions in deciding on the extension of the framework. The objective is rightly to limit the expansion of non-bank to non-bank unregulated transactions.

In any case, it is likely that the level of non-bank transactions will increase as a result of the bank capital rules.

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.

For regulated entities, such as banks and broker/dealers that are subject to capital requirements, we believe that the prudential approach proposed by the FSB is the best for the following reasons. Unlike the market-based approach, this approach is flexible: banks and broker/dealers are allowed to trade under the floors when needed, being then penalized by a higher capital charge attached to the particular transaction. This capital charge creates strong economic incentives for banks and broker/dealers to raise the haircut level while still allowing for flexibility, which preserves market liquidity. The prudential approach would also place a greater reliance on the capacity of the banks to assess the creditworthiness of their counterparties. Therefore, we strongly support the FSB's proposal to incorporate the numerical haircut floors into the Basel III framework.

This approach is, however, not applicable to most entities of the shadow banking sector. It therefore appears to us that it is inevitable that some differences will exist in the way the principles will be implemented. This is, however, not a sufficient reason to abandon prudential based regulation for banks and broker/dealers.

We note that there may be legal changes required in some jurisdictions to allow this regime to be introduced to some classes of non-banks. We would also like to highlight that the securities

financing transaction markets in the EU and in the US operate differently. Even a common regulation may have different effects in these two markets, and the proposed FSB framework opens the door to different implementation approaches. Therefore, there is a need for international coordination so that jurisdictions move in the same time in the same way in order to prevent regulatory arbitrage.

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?

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?

It is not clear that there is a real way to monitor this type of activity. Therefore, it will be challenging to identify different forms of avoidance. As such, GFMA cannot comment on this question.

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 noted throughout our earlier responses to the FSB's consultation, the focus of the haircut regime should be on the activity rather than the entity-type. The regime appropriately includes in its scope those transactions that represent true financing transactions and that scope should be carried over to the non-bank to non-bank transaction area.

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?

GFMA assumes that, for purposes of this question, the materiality threshold would reflect a level of activity of the non-bank in the securities financing markets below which it would not need to comply with the framework and would pose minimal risk to these markets. Without more clarity as to the entities that are included in the term non-bank and the overall size of the non-bank to non-bank market, it would be difficult to recommend a materiality threshold.

Q8. Do you see the need for a phase-in period in applying numerical haircut floors to non-bank-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?

GFMA believes that some transition period would be necessary, particularly if significant additional legal changes (including legislation that might be required to allow this regime to be introduced to some classes of non-banks) will be needed. Some firms, as well, may need to develop or enhance internal operations systems to meet any new requirements and a transition period should take this into account. Finally, we would also expect that any transition period take into account the overall coordination among jurisdictions to ensure a level playing field over consistent time frames.

The continuing engagement of the FSB with market participants on the haircut framework is greatly appreciated and has resulted in an approach that can meet the FSB's financial stability goals without harming beneficial market functioning. We would be please to discuss any of these requests for clarification and responses to the consultative questions in further detail, or to provide any other assistance that would help with the FSB's review. Please contact GFMA by email if you should require further information: Sidika Ulker (sidika.ulker@afme.eu) and Robert Toomey (rtoomey@sifma.org).

Yours sincerely,

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