European Fund and Asset Management Association

EFAMA's COMMENTS ON THE INTERIM REPORT OF THE FSB WORKSTREAM ON SECURITIES LENDING AND REPOS
MAY 2012

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 59 corporate members approximately EUR 14 trillion in assets under management of which EUR 7.9 trillion was managed by approximately 54,000 funds at end March 2012. Just above 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.

Investment funds are important players both on the securities lending market (where investment funds act as lenders of securities) and on the repo markets.

Representing the investment funds industry in Europe (i.e. a significant part of the "buy side"), EFAMA is therefore grateful to the FSB to have the opportunity to provide views on the interim report of the FSB Workstream on securities lending and repos.

Preliminary remarks

Before commenting more specifically on the contents of the Interim Report of the FSB Workstream on Securities Lending and Repos, EFAMA wishes to make the following preliminary observations:

- The conditions under which European Investment funds are authorised to engage in securities lending or repo transactions are already subject to regulation at EU level (notably through the UCITS directive which sets limits on counterparty exposure, borrowing limits, ...) supplemented in many EU Member States by extensive regulatory requirements at national level. Repo transactions will also be further regulated at EU level by a number of initiatives harmonising financial collateral such as the Settlement Finality Directive, Collateral Directive or the Securities Law Directive. Securities Lending and Repos will also be additionally regulated by ESMA when its guidelines on "UCITS ETFs and Other UCITS issues" will be adopted. In

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combination with the reporting duties to become mandatory in Europe in relation to securities lending and repos, we believe these measures already address most concerns raised by the FSB in its Interim Report and could probably serve as a regulatory benchmark for other market participants engaged in these activities.

- Whilst we understand that securities lending and repos are being perceived by the FSB as a possible source of systemic risk because of their potential to facilitate maturity/liquidity transformation and to contribute to the build up of leverage, we also wish to underline the benefits that ancillary portfolio management techniques such as securities lending bring not only to the investors in our investment funds (additional revenues generated by the lending of securities enhance returns on their portfolio) but also to the markets (the availability of securities through securities lending translates into liquidity for the settlement of transactions). Therefore, in considering new regulations for securities lending or repos, regulators need to balance the benefits to the markets and to the investors with the need to mitigate risks.

- Given the global nature of securities lending and repo activities and the interest by regulators in multiple jurisdictions, we recommend an internationally coordinated approach to standards and regulation. EFAMA therefore very much welcome the work performed by the FSB in this area and is keen to continue assisting the FSB throughout the next phase of its analysis and policy making..

Comments on the Interim Report

1. Market overview

Generally speaking, EFAMA believes that the report provides a comprehensive and reasonably sound depiction of the securities lending and repo markets. In particular, we agree that it is helpful to consider the securities lending and repo markets as distinct segments and to identify their specificities and their possible relations to shadow banking. Indeed, whilst securities lending and repo are both collateralised transactions that share common features, it is important to recognize that the markets are markedly different with different demand drivers, stakeholders and levels of post-trade complexity.

This being said, we believe it is important to clarify that, in Europe, traditional investment funds such as European UCITS and other securities funds with UCITS-like set-up[1] are

[1] With the term “traditional investment fund” we are referring here to UCITS and other regulated and supervised investment funds investing predominantly in transferable securities.

certainly active in the "securities lending segment", but should not be associated with the "leveraged investment fund financing and securities borrowing segment". Leverage in UCITS can be only incurred through the use of derivatives as direct borrowing is limited to temporary transactions not exceeding 10% of the fund assets[2]. Hence, the 140:40 (or usually 130:30) strategies mentioned in footnote 11 are realized solely by taking short positions through derivatives and have nothing to do with borrowing of securities for the purpose of physical short selling. The reverse repo transactions occasionally concluded by traditional investment funds are also not suitable to create leverage in the fund portfolio.

2. Key drivers for the securities lending and repo markets

EFAMA broadly agrees with the analysis made by FSB and the description of the key drivers which are not necessarily the same for securities lending and repos activities.

However, we would like to add the following in relation to some of the drivers identified in the FSB interim report:

Firstly, regarding the forth mentioned key driver (Demand for associated "collateral mining" from banks and broker-dealers), we believe that the demand for repos is also to be seen from the perspective of a regulated investment fund.

After entry into force of the European Market Infrastructure Regulation ("EMIR") due for beginning of 2013, a sharp increase in the market demand for liquidity must be anticipated. This is due to the fact that the central clearing of standardized OTC derivative contracts to become mandatory under EMIR will require collateralization with highly liquid assets. Similar standards are currently under discussion for collateralization of bilaterally cleared OTC trades.

Regulated investment funds will be forced to provide government bonds or cash as collateral either in the clearing process or for OTC derivatives not being subject to any clearing obligation.

Additionally, it is likely that the manager of a regulated investment funds will be forced transforming assets ineligible as collateral into cash collateral via repos in order to remaining able to hedge existing market risks via OTC derivatives without contravening to prospectus' investment rules.

[2] Cf. Article 83(2) of Directive 2009/65/EC (UCITS IV-Directive).

Consequently, it is the entire financial industry that will need to find and deliver the liquidities to both continue to deliver servicing and deliver the required guarantees.
Secondly, concerning the fifth key driver (Demand for return enhancement by securities lenders and agent lenders), we are of the opinion that it is inaccurate to state that fund managers enter into security loan transactions as lender in order to gain liquidity for collateralizing OTC derivatives, as it does not reflect the market practice.

Additionally, the benefit for final long-term investors remains a higher return.
While repo is beneficial to preserve liquidity (especially in EMIR perspectives), securities lending is an important elements to increase returns for long term investments.

For long time investors, the benefit is not for leveraging purpose. This is an ancillary business to support better revenues for the investors as both the performance of the funds and the assets that are lent are creating the revenue of fund instead of the sole management decisions.

3. Location within the shadow banking system

EFAMA would like to remind that the re-investment of cash collateral into low risk money market instruments are in the interest of the investors as the collateral taker is obliged to pay interest on the amount received.

Investing cash collateral into short term money market instruments reduces the financial burden of the interest payment obligations.

Additionally, under master agreements commonly used by the investment fund industry, repo transactions include the obligation to repurchase the relevant assets at a predetermined price (usually expressed as the original selling sale price plus the agreed interest). Any variations in the market price of the assets under the repo transactions are subject to collateralization.

We therefoe do not agree with the idea that entering into repos would increase the market exposure of a vehicle under the investment rules of regulated funds.

4. Overview of regulations for securities lending and repos

As already mentioned in our preliminary remarks, engagement by European investment funds in securities lending or repo transactions is partly regulated under the UCITS Directive

with further standards applicable at national level in many EU Member States (these regulatory measures are only partly reflected in the FSB Interim Report).
Concerning the regulation which is already in place or will come into force in a near future at EU level, we wish to point out in particular the following:

UCITS Directive:

1° Counterparty credit risk:

- The counterparty risk limits and collateral rules in the UCITS framework ensure that at all times the exposure of a fund to a single counterparty is managed to a very low level.

- Efficient portfolio management techniques like securities lending and repos are taken into consideration in the global exposure and counterparty risks for UCITS.

- Borrowing by a UCITS is limited to temporary transactions not exceeding 10% of the fund assets (meaning that UCITS cannot build up leverage through the borrowing of securities)

2° Liquidity risks:

- UCITS management companies are also subject to stringent requirement in relation to risk management and risk measurement (including an appropriate liquidity risk management process).

ESMA Guidelines on UCITS ETFs and other UCITS:

ESMA is also currently finalizing guidelines for UCITS (expected to be adopted by the end of June 2012) which will most likely contain additional rules on securities lending and repos for all UCITS (including, in particular criteria regarding the quality of the collateral received as well as further guidelines concerning the re-use/rehypothecation of collateral and the reinvestment of cash collateral)

5. Financial stability issues.

EFAMA would like to express the following comments on the financial stability issues raised in the interim report in the perspective of the European funds industry.

- **Lack of transparency**

EFAMA fully supports the need for further transparency for regulators around the world, creating a level playing field applicable similarly across countries and for similar activities.

EFAMA would however strongly welcome a global approach across legislative initiative and across countries in terms of reporting. The regulation on trade repositories or the future consolidated tape in MiFID should be bear same reporting requirements uniformly applicable.

Some provisions in the revised MiFID and MiFIR review as well as in EMIR, amongst others, have similar transparency requirements that are heavily debated.
In order to avoid important development having costs that would impact final investors, we strongly advocate for the creation of standard criteria applicable across legislations.

It will be important to firstly consider what data will be useful for this purpose, and then to consider the mechanisms for obtaining this. The majority of the data is already largely reported on a daily basis. We believe that developing the transparency that will be required should be straightforward. We are keen to work with the FSB in this area and are attaching a summarized version of our concerns raised by MiFID in order to illustrate our views.. We would strongly support a global approach to this issue such that there are no differences in the reporting obligations of market participants in the major markets of the world.

Additionally, we would like to insist on the careful legislative set-up required for the creation and implementation of Central Clearing. Central Counterparties (“CCPs”) are often viewed as a potential source of increased transparency and risk reduction within the securities finance industry. However, currently, no CCP model is created in a way that would reduce the risk exposure of beneficial owners. Current models would require e.g. the agent lender to transact with a CCP clearing member, thus there would remain a bi-lateral credit exposure to the agent lender. Further, a CCP would add additional costs to the securities lending value chain which would generally create higher borrowing costs for more credit worthy end users.

- **Procyclicality of system leverage/interconnectedness.**

Whilst there is a theoretical case for assuming that securities lending markets are procyclical, we do not believe that this is yet proven or should be a major area of concern. If regulators are concerned about growth in system leverage, we believe that it is better to consider ways of addressing this directly, rather than through the securities finance market.
Before considering policy options in this area, we believe that further analysis is required to ensure that there are real concerns that need to be addressed and that the measures do not unduly detract from the benefits that securities lending and repos provides.

If the underlying concern is the use of sec lending by banks and brokers as a source of short-term financing, regulators should address that issue directly by imposing liquidity requirements on those banks and brokers, rather than indirectly by regulating the securities lending markets and thereby risking harm to markets and investors.

Regulators should not attempt to artificially limit procyclicality. For example, limits on changing collateral margins will have the opposite effect. If lenders cannot adjust margins on loans to a counterparty with declining creditworthiness, they will simply use a more straightforward option – recalling loans to reduce overall counterparty exposures. This, in turn, may be more procyclical than allowing margin adjustments.

Regarding the collateral velocity, as most of the regulated investment funds in Europe have no or limited capacity to actively re-use the received collateral, we believe that regulated funds industry is not active participant in the re-use process.

- **Potential risk arising from fire-sale of collateral assets.**

Traditional investment funds are usually under an obligation to use highly liquid and safe assets for the collateralization of their securities lending and repos activities which fairly reduces the risk of market turmoil in case of collateral sales.

Besides, as said above in the first point of this section (Lack of transparency), the implementation of CCP will increase the need for collateral. The volume of collateral for securities lending or repo transactions then appears to be minor compared to the anticipated collateral needs by CCPs in the context of OTC derivative clearing. Indeed, we think that limitation of eligible collateral for CCP clearing to only a few asset categories as envisaged under EMIR might much stronger increase the stability risk from fire-sales than any realization of collateral by securities lenders or repos activities.

- **Insufficient rigor in collateral valuation and management practices.**

EFAMA does not understand the reference to the inadequate valuation practices observed in the asset-backed securities market.

We indeed believe that an adequate mark-to-market, possibly daily ran as for most regulated funds, is the common practice and offers the required level of valuation and proper means to require the owed collateral.

Should the FSB aim at streamlining or enhancing the valuation standards for collateral, we would be glad to contribute to the corresponding regulatory debate.

Brussels, 25 May 2012

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