Ref: CHC/21/H24
May 25, 2012

Comments on the Financial Stability Board's Consultative Document: *Interim Report of the FSB Workstream on Securities Lending and Repos*

Japanese Bankers Association

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the consultative document: *Interim Report of the FSB Workstream on Securities Lending and Repos* released on April 27, 2012 by the Financial Stability Board (FSB).

We hope that our comments below will assist in the remaining work towards finalizing the rules by the FSB.

[General Comments]

We understand the purpose of the shadow banking regulations and the classification of market segments described in the Interim Report. However, the ″transaction types″ and ″types of transaction participants″ that are to be regulated should be firstly clarified -i.e. repos associated with some illiquid assets and repos leading to high leverage transactions such as hedge funds that are currently not being subject to regulatory supervision. The consistency with various regulations addressing the financial crisis should also be considered.

In considering supervisory and regulatory proposals, quantitative and qualitative analysis should be performed on the pervasive effects on banks that are already subject to the supervision of regulators and on the economy, in order to ensure that such proposals will not incur unintentional and adverse impact. Moreover, from a financing instrument perspective, any necessity of proposing supervisory and regulatory requirements should be determined after making a comparison analysis in terms of the costs and security between repos and the other financing instruments.

If a broad range of regulations on securities lending and repos markets are to be uniformly implemented, we are afraid that it may place restrictions even on certain repos that contribute to the stabilisation of the financial system that provides the liquidity to the market. This would

create the risk of deterioration in the functioning of the market which would contradict the objectives of the regulations. Therefore we request careful analysis and consideration.

As such, any differences in substantial risks under market practices across jurisdictions should be reflected, for example, by focusing on transactions which use low-credit-quality securities or other similar instruments as collateral.

Particularly, government bond repos, which are used by banks as financing instruments and that contribute to the stabilisation of the financial system by supplying liquidity to the markets, should be separately discussed from other transactions addressed in this consultative document.

[Specific Comments]

1. Relationship between the regulations in the report and the other regulatory reforms after the financial crisis

As referred to in the Interim Report, various regulations for securities lending and repos have been established in the wake of the financial crisis, such as settlements of inter-dealer repos by central counterparties (CCPs), the Basel III regime, restrictions on repo transactions by money market funds (MMFs) and the tightening of the eligibility criteria for the acceptance of collateral. We expect the substantial effects of such regulations and the market practice of each jurisdiction to be fully considered.

Based on the descriptions in the Interim Report the key issues of post-crisis regulations for securities lending and repos are: (i) the risk of providing securities with low credit quality as collateral, (ii) the risk of extending excessive credit such as by clearing banks in tri-party repos, and (iii) the risk of market illiquidity caused by concentration on selling particular bonds at the time of credit uncertainty. Various regulations or other measures have been put into effect to address these issues after the financial crisis and have had positive impacts on a global basis. These impacts should be fully evaluated to avoid giving rise to negative side effects resulting from excessive regulation.

2. Risks associated with the shadow banking system (Section 3; Pages 3-4)

To our understanding, the Interim Report indicates that risks associated with the shadow banking system are basically attributable to transactions which use low-credit-quality securities or other similar instruments as collateral.

It is our concern that, if further regulations on the shadow banking system are imposed globally and uniformly, it may lead to excessive regulations for the countries/jurisdictions whose risks associated with the shadow banking system are considered to be relatively low, such as Japan. If a new regulation has an impact on repos collateralised with government bonds or other similar instruments, banks which serve important intermediary and settlement services may face significant costs to comply with such a regulation. In addition, given the current low interest rate environment, further margin restrictions may affect the function of repos. These will not contribute to the stabilisation of the entire financial market.

Therefore, regulations or other relevant measures should be discussed by focusing on certain transactions, for example, that use low-credit-quality securities or other similar instruments.

In discussing the location of risks, it is crucial to thoroughly consider the difference in substantial risks under market practices among jurisdictions. We believe that at least the transactions using high-credit-quality bonds such as Japanese government bonds (JGBs) should be generally scoped out from the shadow banking discussions.

3. Inter-linkage of the four market segments (Section 1; Pages 1-5)

The four market segments set forth in the Interim Report are closely inter-linked. In addition, the possibility of risk materialization depends on the market participants or their activities rather than on the market segments. We understand analyzing by market segment is useful in order to understand the overall picture of the market; however, it would be more meaningful to focus on the transaction participants and their activities which require tighter regulations in order to consider more practical and effective regulations.

Given the above, we recommend that the regulatory discussions should be focused on the transaction participants and relevant activities which require more in-depth regulations e.g. on short selling by funds or on transactions using low-quality securities and other similar instruments as collateral.

4. Concern over excessive regulations on banks (Section 4; Page 10)

As stated in the Interim report, repos executed by banks are subject to the Basel III capital regime and other requirements. Regulations for securities lending and repos differ among jurisdictions. Moreover, uniformly applying additional regulations to market participants may

give rise to excessive regulation over specific entities including banks.

Therefore, it should be taken into account that whether any other regulations may be applied to market participants and what effects these regulations could have on them.

5. Development of guidelines on market practices and industry standards (Section 4.2.3; Page 12)

Section 4.2.3 *Collateral guidelines* of the Interim Report indicates that while the US sets "minimum levels of haircuts and margins at 100%", specific guidelines concerning the margin call criteria under bilateral transactions, or prices of bonds to be applied for margin calls have not been stipulated yet. Therefore, under current practice, parties to the transactions discuss and "reasonably" determine such conditions.

Developing the collateral guidelines may contribute to the "smooth execution of transactions" and the "standardization of risk management" in the above-mentioned cases of the US ..

6. Views on minimum margins and haircuts and other regulatory tools (Section 4.2.3; Page 12)

Regulations on minimum margins and haircuts, reinvestment and other regulatory tools should be considered by taking into account market practices in each jurisdiction and the credit quality of securities provided as collateral. Therefore these regulations should be set and applied globally at a minimum level. We are particularly concerned about imposing any regulations on repos collateralised with government bonds since it would have a significant impact.

The market practices of securities lending and repos vary in each jurisdiction. In applying the regulation to government bonds and government agency bonds, it should be taken into account the differences in credit quality of each jurisdictions and institutions, rather than applying uniform regulations.

7. Degree of enhancement of regulations associated with the repos market (Section 5; Pages 14 - 18)

While fully agreeing with the "potential financial stability issues" (including transparency, procyclicality, and leverage) identified by the FSB, we have a concern that excessively enhanced regulations may lead to a decrease in liquidity of the repos markets and a reduction in

the market size.

Excessively enhanced regulations has a significant impact on the government bond repos markets in the US and Japan, which is the main financing tool for Japanese banks. It will also affect the price formation in those markets. Hence we would expect appropriate consideration of market practices across jurisdictions.

8. Necessity of data development (Section 5.1; Pages 14 to 15)

We understand the necessity of developing micro-level data and improving disclosure to clients. Nonetheless, with respect to micro-level data (transaction data) and corporate disclosure, it should be avoided to impose overlapping rules or to take careful actions, by considering the balance between the practical burden placed on financial institutions and the benefit of the regulations.

If a certain regulation is to be imposed on data development, we believe that the scope of the regulation should be limited, i.e. to transactions that provide securities with lower credit quality as collateral.

For example, if reporting on transaction data of securities lending and repos becomes mandatory in the future, same as over-the-counter derivatives, this may place a significant burden on market participants and lead to a reduction in the market size and functions.

To cite the Japanese market as an example, the necessity of capturing and reporting individual transactions is viewed to be low from a risk identification perspective, because securities lending transactions and repos are in general settled via the central counterparties (CCPs) or netting in practice.

9. Issues on financial system leverage/interconnectedness arising from repos (Sections 5.2 to 5.4; Pages 15 - 17)

In discussing additional regulations on repos, the adverse impact on the financial markets and the real economy by the cumulative effects of such regulations as well as the leverage ratio and liquidity regulations under Basel III should be sufficiently assessed. Moreover long-term transition provisions should be provided if the additional regulations were to be introduced.

The leverage ratio and liquidity regulations under Basel III have already considerably mitigated excessive leverage and dependency on financing which use repos. In addition to such

regulations, setting restrictions on repos in a uniform manner would lead to acceleration of deleverage and to increase in demand for long-term financing, which could destabilise the financial markets and real economy. Hence, this issue should be carefully discussed.