J.P.Morgan

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Via email: fsb@bis.org

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

Re: Comments on Interim Report of the FSB Workstream on Securities Lending and Repos

Dear Sir or Madam,

We have reviewed and considered the Interim Report of the FSB Workstream on Securities Lending and Repos, dated 27 April 2012 ("the Report"), and are pleased to provide you with our comments.

We consider the Report to provide a fair and balanced description of the current securities lending and repo market. However, we believe that there are some additional considerations that should be included in the final analysis. A number of our comments and suggestions on the Report relating to the Repo market are already set out in responses drafted by various market associations - such as SIFMA's response, dated 25 May 2012, and with respect to the Securities Lending market as set out in the joint response of the RMA and ISLA, dated 25 May 2012. Whilst we share the views expressed in those documents, we would like to take the opportunity to provide some additional points. For your consideration, we have set out our comments below, with a particular focus on Section 5 – Financial Stability Issues.

Section - 1 Market Overview

This section refers to four market segments. While we agree with the four segments referred to, a distinction should be considered for Central Banks, given their unique role in the financing markets. Specifically, the repo markets are used by these entities as a means to implement monetary policy, and this activity affects the availability of collateral in the overall market.

Section 3 - Location within the shadow banking system

It is discussed that securities financing transactions are typically much shorter in duration than the maturity of the underlying securities involved in these transactions. While we agree with this statement, it is important to note that the maturity of the underlying securities is not always relevant. This is specifically the case when liquid securities are used as collateral and/or appropriate haircut, pricing and regulatory capital policies are applied.

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Section 5 - Financial Stability Issues

Firstly, we suggest highlighting the changes that were made to the US tri-party repo market model in 2011, which provided a meaningful foundation for increased financial stability by continuing to reduce the extent of intraday credit provided by clearing banks. The private sector Tri-Party Repo Market Model Reform Task Force recommended initiatives that significantly reduced clearing bank credit exposure, improved transparency and more properly aligned risks. During 2011, market improvements driven by industry initiatives included:

- Implementing three-way trade confirmation, which increased lender involvement and market transparency. J.P. Morgan met the deadline on time by delivering new technology, reporting and processes to support both dealers and investors
- The required introduction of auto-substitution capabilities, which J.P. Morgan has already complied with, replaces intraday liquidity by substituting securities for securities. The impact is that repo trades no longer need to be unwound because of intra-day substitution capabilities
- Moving the settlement window from start of day to 3:30 p.m., which reduced the duration of intraday credit from a full business day to a brief 1 ½ - 2 ½ hour window

Secondly, as the topic of CCPs is not referenced in this document, we suggest giving the market an opportunity to be consulted before any recommendations would be made in this respect. For example, issues may arise with:

- repo counterparties that are not a clearing member
- standardization of repo terms and contracts
- a CCP's capacity to administer a participant's default, which depends on its operational capabilities and its ability to rapidly obtain liquidity to meet its assumed settlement obligations
- concentration risk when clearing all repos through a limited number of CCPs

The above-mentioned issues are also discussed in a CPSS working paper[1] which concludes that central clearing facilities for repos are not always the optimal solution to achieve more financial stability.

Section 5.1 – Transparency

We agree that sufficient market transparency is one aspect that will contribute to greater financial stability. As a tri-party repo and securities lending agent, we appreciate that the FSB recognises the level of transparency which is already a feature of these markets.

Our assessment, as recognised by the FSB in Section 5.1(i) and Annex 2, is that there is extensive information available from commercial data providers. We contribute data from our agent lending and tri-party repo businesses to the main commercial data vendors. Moreover, we provide extensive information to the New York Federal Reserve on repos, which is published on a regular basis.

We are supportive of arrangements to ensure that similar data will be available to supervisory authorities, as long as requests for data are proportionate, protect legitimate concerns about confidentiality (for example by ensuring that client confidentiality and bank secrecy rules are

[1] Committee on Payment and Settlement Systems – Strengthening repo clearing and settlement arrangements, September 2012 www.bis.org/publ/cpss91.pdf

observed, and that commercial confidentiality is respected, so that the data cannot be misused for competitive or speculative purposes by third parties) and do not place a substantial administrative or financial burden on market participants.

Section 5.2 – Procyclicality of system leverage/interconnectedness

In the past ten years, collateralised financing has assumed a more significant role, particularly when contrasted with unsecured financing. It is important to keep in mind, when considering procyclicality, that one of the dynamics of financial crises is contraction of credit and deleveraging across all forms of financing. The use of collateral helps to mitigate the tightening of credit requirements, by providing greater certainty and confidence in counterparties and collateralised transactions.

This tendency is evidenced by the data contained in the ECB Money Market Survey or the ICMA Repo Survey, which both point out how, during the 2007-2009 credit crunch, collateralised lending held up well and the most liquid collateral was only marginally impacted by the contraction of credit. It should also be considered that collateralised credit can represent a multiple of the unsecured exposure to the same counterparty; so that, if collateral arrangements are reduced, the overall level of credit granted to that counterparty will be expected to fall correspondingly.

Our experience is that the market has reacted to the financial crisis by adopting more risk-aware practices, which are expected to reduce the likelihood of procyclical behaviour. At the outset of the financial crisis, we observed that our clients were becoming increasingly focused on the assessment and management of risks associated with securities lending and repo transactions, including in relation to the quality and quantity of collateral. In the period between August 2007 and September 2008, the market underwent a qualitative transformation, as clients revisited their exposures to various risks, sought better and more frequent reporting to inform themselves about their positions, and made adjustments to their collateral and cash reinvestment guidelines. Where there had previously been a broad consensus about the acceptability of certain risks, clients began to differentiate themselves by more carefully aligning the guidelines to their specific risk management approaches.

We have long supported best-practice risk-mitigation measures, such as separate client accounts for reinvested collateral, and responded to market evolution by making a number of enhancements within our securities lending programme, in order to support demands for better and more frequent reporting, as well as greater flexibility in the specification of collateral and cash reinvestment guidelines. Overall, our assessment is that changes in both client risk management practices and agent lending service offerings have tempered procyclical behaviour to a meaningful degree.

As a general market observation, due to the collateral eligibility restrictions imposed by legislation (pending and suggested), we anticipate collateral swaps and other upgrade trades to increase. We would welcome FSB commentary on how these increased activities by levered intermediaries change or influence the assessment of systemic risk, if at all.

Section 5.2.2 – Haircuts

We share the FSB's concern that haircuts can be overoptimistic; particularly when no haircut is taken. Prudent risk management practices require a haircut to be applied for non-cash collateral, but we do not believe that a specific level should be established, either as a minimum or standard rate. It would be difficult for a haircut formula to be prescribed by regulation, which would cover the

actual risk of individual transactions. We are of the opinion that haircuts should be based upon a case-by-case assessment of:

- The nature and value of the asset on loan
- The nature and value of the collateral received
- The duration of the loan
- Counterparty risk characteristics, including collateral correlation

Our practice is to be consistent in setting haircuts, having regard to the risk of the transaction and the factors listed above, and not to base them only on general market conditions at the outset of the securities loan. As lending agents, we are subject to the instructions of our clients.

We do occasionally modify haircuts in our securities lending programme, including by reference to these factors, but endeavour to do so with the cooperation of counterparties before they are implemented. In our experience, these changes are not dramatic, primarily, because reasonable haircut arrangements are put in place at the outset. Moreover, we do not only look at changes in the value of assets; we also look at the quality of the relevant assets.

Section 5.2.3 – Collateral velocity and Section 5.3 - Other potential financial stability issues associated with collateral re-use

The Report provides good insight into potential systemic concerns in sections 5.2.3 and 5.3 when referring to issues around collateral rehypothecation and velocity. These concerns focus on increased interconnectedness between market participants, but do not provide analysis on how restricting these activities can potentially reduce liquidity in the underlying securities markets. Furthermore, it should be noted that collateral re-use creates a new transaction which is subject to existing leverage and capital rules. In light of proposed regulation, such as the restriction on rehypothecation for non-cleared inter-broker/dealer swaps included in Dodd-Frank, we encourage further analysis.

Rehypothecation is an effective tool to increase market liquidity, however, it is operationally complex (especially in light of collateral substitutions) and therefore requires a robust infrastructure.

Finally, kindly note that our agent lending programme does not allow for reyhpothecation of non-cash collateral received in respect of loaned assets.

Section 5.4 - Potential risks arising from fire-sale of collateral assets

It should not be assumed that, in times of market stress, fire-sales of collateral would inevitably occur. Within our own agent-lending programme, a meaningful proportion of loans are collateralized by cash, and a substantial portion of the cash collateral investments are typically of a very short term or highly liquid. Moreover, the interests of all market participants, including the agent-lender (which, for example, could have given an indemnity to the lender) are for the orderly and prudent liquidation of collateral positions, in order to preserve the value of the collateral so far as possible.

In a default situation, it should be taken into consideration that lenders will also be buyers of the originally lent assets, using the proceeds of liquidated collateral to fund these purchases, which can provide liquidity to the market during periods of stress.

The points referred to in Section 5 – Financial Stability Issues, in relation to developments in the tri-party repo market, are also relevant to consider with respect to the risks of fire-sales of collateral assets. In particular, the move towards higher quality collateral may help mitigate the pressure to liquidate collateral positions quickly.

Section 5.5 - Potential risks arising from agent lender practices

We note the Report's reference to arrangements to ensure that custodians are responsible for shortfalls in client assets which are entrusted to them for safekeeping; including pursuant to the EU Alternative Investment Fund Manager Directive. In practice, those performing safekeeping/custody functions are generally responsible to return to their clients the assets which are entrusted to them, unless their inability to do so is caused by events beyond their reasonable control (such as force majeure). This responsibility is independent from the lending agent's indemnity of lenders, in the event that borrowers fail to return borrowed assets, and has a different basis. The custodian's position arises from law, whereas the lending agent's indemnity is based on a commercial arrangement.

Moreover a concern is raised that beneficial owners of lent securities may reduce the rigor in their counterparty credit risk management practices, due to the view that indemnities provided by agent lenders will completely protect against the risk of counterparty default. While we agree that beneficial owners need to continue to provide scrutiny into the scope of the indemnity (e.g. capped liability structures) as well as the quality of the counterparties, this section does not address the requirements regulated institutions already have to comply with, when providing such indemnities to their clients. Certain agent lenders, including JPMCB, already have comprehensive regulatory requirements regarding risk management and risk-based capital requirements for off-balance sheet commitments, including securities lending indemnities. We believe systemic risk issues reside around the fact that not all agent lenders are required to comply with such regulatory regimes.

Section 5.6 - Shadow banking through cash collateral reinvestment

With respect to the FSB's concern that agent lenders do not share in losses arising from the reinvestment of cash collateral, kindly note that the basis of the agent lender's fee is the ongoing activity of earning a spread, and not the market value of the collateral as such; i.e., the agent lender does not share in any investment gain or loss arising from the reinvestment of cash collateral. Any revenues associated with securities lending activity, including those from cash reinvestment, are split in a pre-determined manner between the agent lender and the lender, and should be considered a remuneration for the services agent lender provides to the lender (including a premium for the indemnity provided by the agent). In many cases, the allocation of revenue will be the same regardless of whether a given loan is secured by cash collateral or non-cash collateral. In the case of a sale of a cash collateral investment, both the gains and losses are for the account of the lender.

We should note that cash reinvestment guidelines are defined and agreed by our clients, as their own investment decisions. In our agent lending programme, we do not have the discretion to select cash collateral reinvestment options outside of these mandates.

While this paragraph provides a holistic view of cash reinvestment practices, we would welcome more information or commentary on how current and future regulations support prudent practices and minimize systemic risk. Specifically, we suggest considering the following aspects:

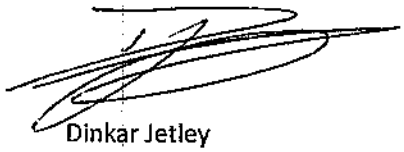
- LCR, NSFR and other Basel III rules will impact the availability of short term, "money-like" products from regulated institutions, as these firms will be heavily incented to shift to longer-term liabilities. This may lead to a reduction of issuance of eligible unsecured as well as secured debt. Further regulatory restrictions that include strict maturity and/or rating agency thresholds may further restrict the universe of eligible assets available for cash collateral reinvestment
- The interplay of these two aspects may create artificial imbalances in short-term interest rates and may potentially result in the inability to support the existing level of agent lending program activities collateralized with cash

Section 5.7 - Insufficient rigor in collateral valuation and management practices

We share the concern of the FSB that certain assets can be hard to value, and that the financial crisis exposed weaknesses with pricing of illiquid assets. We note, however, that the use of tri-party collateral agents tends to support increased rigor with respect to valuation of collateral. Tri-party agents utilize independent valuations sources and transparent pricing policies which are agreed upon by both lender and borrower.

We trust that the foregoing is helpful to your work. If we can be of further assistance, please do not hesitate to contact us.

Yours faithfully,



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