

**Response to The Financial Stability Board's  
Consultative Document:**

**Strengthening Oversight and Regulation of Shadow  
Banking**

A Policy Framework for Addressing Shadow Banking Risks in  
Securities Lending and Repos

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**14 January, 2013**

## **Introduction**

We welcome the FSB recommendations for improving transparency and the regulation of repo's and securities lending.

At the same time, we believe that for credit risk transfers in general, a broader and more focused monitoring response is needed. Effective market monitoring is an essential pre-requisite for shadow banking oversight.

The materials presented remain at a high level and are illustrative only. As such, they outline opportunities for improved efficiency and effectiveness in delivering the targeted outcomes. In need, the presented framework may be implemented without material delay or market disruption. Our underlying assumption is that if these ideas are of interest, further dialogue will follow.

In conjunction with this response, we are also submitting a separate, parallel response to the FSB's Shadow Banking consultation which is referred to in our response below.

## (1) General questions

**Q1. Does this consultative document, taken together with the earlier interim report, adequately identify the financial stability risks in the securities lending and repo markets? Are there additional financial stability risks in the securities lending and repo markets that the FSB should have addressed? If so, please identify any such risks, as well as any potential recommendation(s) for the FSB's consideration.**

Shadow banking (SB) is a process of market-based finance which breaks down credit intermediation into a chain of operations performed by several financial entities (banks & non-banks) interacting and re-distributing risks through the wholesale financial market.<sup>1</sup> SB relies on the wholesale market for funding, notably through repo's and securitization, and on secondary markets for pricing and buying/selling assets and derivatives. SB provides credit both directly and indirectly through transformation and re-distribution of credit, maturity and liquidity risks. It facilitates credit supply by allowing non loan providers to have access to diversified or new credit investments, but also amplifies leverage and pro-cyclicality through financial transformation.

To identify and address financial stability risks, systemic risk monitoring should monitor

- **Systemically important financial activities**, whatever their nature and the nature of the legal entities involved
  - i) The same functional regulation should therefore apply to any legal entity, regulated or not, and
  - ii) Functions should clearly separate activities that support the real economy from proprietary financial activities which transform risk, (i.e. identify activities the fall under functions 4 and 5 as defined in our reply to the first FSB consultative document)
- **Systemically important flows of risk transfers**, creating a broad **chain-of-claims**, i.e.
  - i) Risk transfers which rely upon the same underlying financial asset or refer to the same trigger events,
  - ii) Risk transfers which transform the underlying financial risk, whatever the instrument used to transfer or transform the risk (repo's, securities lending, cash or synthetic securitization)
  - iii) Risk transfers which might create a chain-of-claims due to successive re-leveraging or re-hypothecation, which requires tracking and mapping the flows of risk transfers based on the underlying assets, and identifying the assets/risks which can give rise to systemic runs.

This consultation document, taken together with the earlier interim report, does not identify all the financial stability risks in the securities lending and repo market, nor in the broader credit risk transfer market. Specifically, it does not consider risks arising from the underlying collateral supporting such lending and repo activity. Consequently:

- the **data capture** proposal remains incomplete (the nature of the underlying assets/risks and changes in risk transfer flows are not captured)
- the **toolset** focuses upon identifying and limiting the intensity of risk transformation, without considering whether the transformation is desirable for the economy.

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<sup>1</sup> ICMA Shadow banking and repo, 20 March 2012, compiled for ICMA's European Repo Council (Richard Comotto)

The origins of the 2007 crisis was the over-leveraging and subsequent fall in US house prices. This prompted stress in the by sub-prime mortgage market. Financial losses from the associated securities were then amplified internationally by shadow banking activities.

These concerns apply for all policy consultations seeking to manage systemic risks from risk transformations. **Separating desirable from undesirable activities and tracking material asset dynamic changes are important activities for such policy initiatives.**

**Q2. Do the policy recommendations in the document adequately address the financial stability risk(s) identified? Are there alternative approaches to risk mitigation (including existing regulatory, industry, or other mitigants) that the FSB should consider to address such risks in the securities lending and repo markets? If so, please describe such mitigants and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?**

As explained in our answer to question 1 above, the consultative document does not respond to all financial stability risks, particularly those arising from assets used as underlying or reference assets in risk transfer transactions. It also fails to identify the amplitude and complexity of the chain-of-claims.

There is significant potential for **contagion** if regulators and market participants lose sight of where risks have migrated to in the economy and how much capital supports these risks. The regulatory scope should therefore

- focus upon monitoring movements (flows) in credit risk exposure<sup>2</sup> and the risk capital supporting such exposure. This will enable management of “chain-of-claims” volumes within the financial network, and
- provide incentives for direct transfers from originators to ultimate investors. This should reduce the chain-of-claims between real economy participants and the financial network.

Specific provision should also be made within the monitoring effort to **map interconnectedness** within the financial sector. Monitoring should notably provide transparency around

- the source and destination of risk transfers,
- the nature of the selling and buying counterparties,
- the nature of the assets/risks being transferred (and/or transformed)
- where the capital supporting the transferred/transformed risks ultimately resides, as well as
- the purpose of each transaction<sup>3</sup>.

The fundamental systemic risk management issue is one of **tracking the capital and liquidity that support the assumed risks** and ensuring that this supporting capital does not fall away. Any incremental regulation should be evaluated on its ability to improve such tracking and to match risk to its supporting risk capital base.

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<sup>2</sup> including data relating to underlying asset type

<sup>3</sup> of the 5 economic functions proposed in our response to the FSB’s consultation on Strengthening Oversight and Regulation of Shadow Banking

Similarly, policy recommendations related to **transparency** and **regulation** should enable flows of transformed risks and assets to be tracked at a global level. To support the mapping of inter-connectedness, such tracking should be consistent across all entities, activities and transactions types. It should also encourage simplification of the risk transfer network.

In response to these considerations, we recommend the introduction of **independent utilities to register and monitor all risk transfers**, including those between regulated and non-regulated financial institutions. The primary purpose of these utilities would be to:

- respond to the **data collection** challenges, focusing upon data needed for systemic risk management and network transparency purposes:
  - o a trade repository for all repo's and securities lending transaction would be too broad, as certain underlying asset types pose limited if any systemic concern. At the same time
  - o an isolated monitoring framework focused only on repo's and securities lending transactions would be inadequate as complementary forms of risk and liquidity transformation (e.g. cash or synthetic securitizations) contribute to systemic risk as well. Therefore, linked monitoring is needed.
- help expand the **regulatory tool set** to encourage prudent financial innovation and market participation. For regulated entities, the latter might take the form of
  - o adjusting liquidity requirements in time of stress (e.g. eligibility as high quality liquid assets) and/or
  - o more nuanced capital requirements<sup>4</sup>

For monitoring of systemically important risk transfers, a **trade repository ("TR") of risk transfer trades** would be the most attractive solution. Such a TR would be different from existing or planned repositories per transaction type, as it would

- focus upon **financial asset classes** which are broadly distributed and can generate systemic crisis when credit quality or liquidity deteriorate<sup>5</sup>;
- map and track data for risk transfers that transform financial risks (credit, maturity, liquidity) by either stripping-out or leveraging risks from a specific asset or pool of assets<sup>6</sup>;
- monitor consequential links between any type of **financial legal entity**, be they regulated or not; banks, insurers, funds, SPVs, finance companies, etc,
- identify changes in the **capital and liquidity buffers** supporting these transferred and transformed financial risks, wherever they are in the chain-of-claims.

The specific added value of this TR approach will be to

- establish a **common monitoring architecture** to support transparency and aligned regulation, and
- standardised **information** to limit the potential for further **regulatory arbitrage**.

This TR approach would encourage **regulatory alignment**, desirable SB activity while discouraging undesirable activity. This would include risk transfer regulation across the banking, insurance and shadow banking sectors. For the avoidance of doubt, such realignment would re-enforce the incentives for desirable SB activity while restricting opportunities to introduce "hidden leverage" to the lending markets. It does not intend to weaken existing regulatory frameworks.

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<sup>4</sup> e.g. more calibrated investor RWA requirements for transactions reported in a central repository

<sup>5</sup> ref. to US subprime mortgages in 2007

<sup>6</sup> i.e. currently repo's and securities lending, but also synthetic and cash securitizations

The introduction of TRs would also enable **a simpler, less costly and functionally oriented approach to regulation**<sup>7</sup>. With it policy makers might eventually choose – for example - to use the TR to

- constrain or support specific lending activity in response to cyclical pressures,
- standardise risk transfer capital and liquidity requirements for all financial institution,
- establish independent asset servicing capabilities during periods of stress,
- restrict bank lending to shadow banks,
- etc

All of the above would have the advantage of encouraging

- greater market liquidity,
  - robust balance sheet management solutions for financial institutions (re-structuring their balance sheets to comply with new prudential or internal capital and liquidity requirements), and
  - diversify the investment options for long term investors<sup>8</sup>,
- while discouraging regulatory arbitrage.

The risk transfer market is likely to re-establish itself in one form or another out of the sheer necessity to manage regulated balance sheets. The first challenge is to encourage this re-formation in a way which is **economically desirable** (i.e. broad based, comparatively simple and transparent). The second challenge is to incorporate **infrastructure** within the market which allows regulators to address cyclical pressures in both an anticipatory and remedial way.

Given increased disintermediation of regulated banks and the systemic risks inherent in the current forms of disintermediation, there is some **urgency** for introducing regulatory adjustment and simplification to this market. There is also a growing need to innovate beyond the current atomistic approach to regulation in order to manage information overload, operational inconsistencies and compliance complexity.

**Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe that would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment?**

As noted, we recommend some focused **adjustments to the risk transfer market's infrastructure** to strengthen how it is monitored from both a regulatory and investment perspective.

For systemic risk monitoring purpose, we advocate the introduction of a functional overlay to the existing regulatory framework. This would monitor risk transfer market flows and financial network interconnectedness.

The most significant adjustment would be to introduce **Trade Repositories** (“TRs”) to register and integrate risk transfer information. This would use, amongst other things,

- the loan-by-loan information collected by central banks (like the ECB),
- the new standard legal entity identifiers, which help identify flows from one entity to another.

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<sup>7</sup> See also our response to the FSB's consultation on Strengthening Oversight and Regulation of Shadow Banking

<sup>8</sup> e.g. insurance companies and pension funds

Such centralised and standardised monitoring would materially simplify the market's operations as well as the SB monitoring effort.

The proposed TRs would register transaction specifics protecting transaction-specific confidentiality. The resulting aggregate information will support investors' due diligence and provide regulators with de-constructible data store. This, in turn, will enable analysis of how market developments impact aggregate capital adequacy and interconnectedness. The TRs would operate as a "**public good**".

These TRs will be

- **governed** by representatives of regulators and financial stakeholders (loan originators, investors),
- operated on a **not-for-profit basis**,
- **accessible**, in a controlled way, to consumers, investors, bank and non-bank financial entities and national regulators

**Q4. Please address any costs and benefits, as well as unintended consequences from implementing the policy recommendations in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers, to the extent possible, that would assist the FSB in carrying out a subsequent quantitative impact assessment.**

While a comprehensive TR to track all repo's and securities lending might appeal, it will also prove to be costly, given its breadth of coverage, and require a long development effort to capture all market nuances.

A more selective TR, focusing upon the most commonly traded and transformed risks, should be much easier to develop and cost effective to operate. The product coverage of such a TR may then be expanded over time to encompass a wider range of traded assets. Standardisation will also be important to ensure consistency across regulatory boundaries.

We expect such an approach to be both more cost-effective and easier to implement globally than the alternatives.

**Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks)?**

The individual, "entity" risk of **systemically important financial institutions** is already monitored by prudential regulators. The next steps are to phase in monitoring of

- **Systemically important financial activities**,
  - i) covering all legal entities, regulated or not, and
  - ii) segregating desirable from undesirable activities
- **Systemically important flows of risk transfers**, which create chains-of-claims

We believe that a feasibility study, including prototype TR testing, could be completed within six months. A basic/simple TR could be launched in up to three jurisdictions within 12 months. Depending upon ambition levels, a further 36 months would be needed to develop the TR beyond its basic initial capabilities. All timing estimates incorporate a

certain elasticity driven by investment levels. Overall investment requirements are expected to remain relatively modest. Incremental development beyond the basic initial capability would include the establishment of appropriate inter-jurisdictional data sharing routines, stress testing routines etc<sup>9</sup>. Timing estimates also assume further discussion to agree specifics.

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<sup>9</sup> All estimates incorporate several assumptions, including a clear definition of target outputs, appropriate development resources, constructive/supportive governance, etc.

## (2) Policy recommendations related to transparency:

- (2.1) *Improvement in regulatory reporting*
- (2.2) *Improvement in market transparency*

**Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items.**

We also refer to our responses to questions 3 and 4 here above.

While the FSB's proposed target information is relevant for regulating the intensity of financial transformation in a repo transaction, it does not capture data on

- the underlying **assets** being transferred/transformed (underlying assets will be a primary volatility driver in times of stress),
- the **price** of the transferred risk,
- the **capital** and **liquidity buffers** supporting the risks from a regulatory or economic point of view<sup>10</sup>
- the **risk management** practices of the entities which are selling or buying the transformed risk.

In addition to the data to be collected, regulators may wish to verify that systemically significant and un-regulated market participants have basic risk management capabilities in place. As such, they could verify whether these entities are able to

- assess the economic capital and liquidity buffer needed to support the risk transfer trades they are participating in, and
- report on their total risk exposure for specific underlying collateral.

Restrictions might then be imposed on those significant participants unable to adequately generate such information.

**Q7. Do you agree TRs would likely be the most effective way to collect comprehensive market data for securities lending and/or repos? What is the appropriate geographical and product scope of TRs in collecting such market data?**

As already outlined in our responses to the questions here above, we believe that a TR is the most effective way to collect market data provided that the TR also collects data on

- the risk transfer/transformation **flows**;
- the **underlying assets** which are transferred and transformed; and
- the **capital and liquidity** buffers which support the retained and acquired risks and thereby identify the **interconnections** within the financial network.

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<sup>10</sup> from both a seller's (retained risk) and buyer's (acquired risk) perspective

**Q8. What are the issues authorities should be mindful of when undertaking feasibility studies for the establishment of TRs for repo and/or securities lending markets?**

We refer to paragraph 7 of the *European Parliament Resolution of 20 November 2012 on Shadow Banking (2012/2115(INI))*, which

- “stresses, further, the need to obtain a **fuller overview of risk transfers** by financial institutions, including but not limited to transfers effected through derivative transactions, data for which will be provided under EMIR and MIFID/MIFIR, in order to determine who has purchased what from whom and how the transferred risks are supported;
- emphasises that it should be an objective to achieve real-time **transaction mapping in all financial services** and that this is aided by and can be automated via standardised messaging and data identifiers;
- invites the Commission, therefore, in consultation with the ESRB and international bodies such as the FSB, to include in its report on central data collection the current work on standardised messaging and data formats and the **feasibility of setting up a central registry for risk transfers**, which should be able to capture and monitor risk transfer data in real time, making full use of data provided under the reporting requirements of existing and future financial legislation and incorporating internationally available data”

The aim of this central registry would be to map and monitor material **interconnections** between all financial institutions in real time. Its design should enable greater, aggregate transparency while respecting individual transaction confidentiality sensitivities.

As detailed in our responses to the questions here above, we strongly recommend that a feasibility study be completed to this end.

- (2.3) *Improvement in corporate disclosures*

**Q9. Do you agree that the enhanced disclosure items listed above would be useful for market participants and authorities? Would disclosing any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be disclosed instead.**

We have no particular comment on this question, except that financial institutions (regulated or not) should be able to report on the assets/collateral which are referenced in all their risk transfer trades, and provide information on the capital and liquidity buffers which support these trades.

- (2.4) *Improvement in reporting by fund managers to end-investors*

**Q10. Do you agree that the reporting items listed above would be useful for investors? Would reporting any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be reported instead.**

We agree that the reported items are and should be useful for investors if they incorporate the proposed information on market flows and interconnections. This will allow investors to

better understand the cause of relative price movements and make informed decisions<sup>11</sup>.

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<sup>11</sup> N.b. Investors would only have access to aggregated and relative price movements rather than absolute prices.

## **(2) Policy recommendations related to regulation**

We have no particular additional comment on policy recommendations related to repo regulations, except that the same recommendations should also apply on a consistent basis to cash and synthetic securitizations.

### *(3.1) Minimum haircuts – standards*

**Q11. Are the factors described in section 3.1.2 appropriate to capture all important considerations that should be taken into account in setting risk-based haircuts? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?**

### *(3.1) Minimum haircuts - Numerical floors*

**Q12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?**

**Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?**

**Q14. Are there additional factors that should be considered in setting numerical haircut floors as set out in section 3.1.3?**

**Q15. In your view, how would the numerical haircut framework interact with model-based haircut practices? Also, how would the framework complement the minimum standards for haircut methodologies proposed in section 3.1.2?**

### *(3.1) Minimum haircuts – Scope of application*

**Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?**

**Q17. Are there specific transactions or instruments for which the application of the numerical haircut floor framework may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.**  
**Q18. In your view, how should the framework be applied to transactions for which margins are set at the portfolio basis rather than an individual security basis?**

*(3.2) Cash collateral re-investment*

**Q19. Do you agree with the proposed minimum standards for the reinvestment of cash collateral by securities lenders, given the policy objective of limiting the liquidity and leverage risks? Are there any important considerations that the FSB should take into account?**

*(3.3) Requirement on re-hypothecation*

**Q20. Do you agree with the principles set out in Recommendation 9?**

*(3.4) Minimum regulatory standards for collateral valuation and management*

**Q21. Do you agree with the proposed minimum standards for valuation and management of collaterals by securities lending and repo market participants? Are there any additional recommendations the FSB should consider?**

**(4) Policy recommendations related to structural aspects of the securities financial markets**

We have no particular remarks on this section.

*(4.1) Central clearing*

*(4.2) Changes to bankruptcy law treatment of repo and securities lending transactions*

**Q22. Do you agree with the policy recommendations on structural aspects of securities financing markets as described in sections 4.1 and 4.2 above?**

## Appendix A – References

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## Appendix B – Biographies

**Casey Campbell** holds a BA in Administration from the University of Toronto, Canada and an MBA from Insead, France. From 2006 - 2011 Casey worked in Lloyds Banking Group leading teams responsible for balance sheet analysis, stress testing, loan portfolio optimisation and risk infrastructure re-design. Previously Casey was a consultant with Oliver Wyman, Frankfurt, where he provided risk advisory services to European and North American financial institutions. He also has extensive experience originating and underwriting large, cross-border loans and leases in the European market for GE Capital and for a specialised infrastructure financing subsidiary of the Bank of Tokyo-Mitsubishi.

**Tamar Joulia-Paris** holds various engineering & business management degrees from universities in Belgium and in France. After 10 years in the construction & manufacturing sectors, she joined banking in 1992 to start a new Credit Risk Management unit charged with developing risk infrastructure and management methodologies for the bank's lending & trading books. This included governance, risk appetite, stress testing, risk transfer and liquidity management solutions for the retail, SME and corporate loan portfolios.

Tamar also served on CEBS' consultative panel in 2010, and as an IACPM Board member from 2006 to 2011. She left banking mid-2011 to focus on her academic pursuits as well as senior risk, capital and balance-sheet advisory work in the financial industry. Tamar has authored many articles and is a regular speaker at conferences in the US and Europe.

Further details about us may be found on [www.CreditUtility.eu](http://www.CreditUtility.eu).