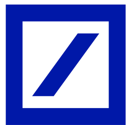
Deutsche Bank



14 January 2013

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Secretariat of the Financial Stability Board,
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Dear Sir / Madam,

Deutsche Bank response to consultation on Strengthening Oversight and Regulation of Shadow Banking Policy: a Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

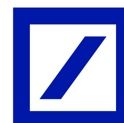
Deutsche Bank welcomes the opportunity to respond to the recommendations proposed by the Financial Stability Board (FSB) for addressing shadow banking risks in securities lending and repurchase agreements (repos). This report's findings, combined with the interim report published earlier this year, represent a thorough and useful analysis with recommendations that strike a balanced tone for the approach to regulation of securities financing markets. However, in translating what are sound principles into concrete measures, more thought should be given to unintended consequences and interactions with other regulation and regulatory proposals.

As the report recognises, securities financing markets are an essential component of the financial markets as a whole and, as such, regulatory interventions in this space need to be advanced carefully. The FSB is therefore right to stand by a commitment to proportionate regulation and to identify greater transparency and understanding of the dynamics and risks within this market as a key priority. In order to avoid unintended consequences, we believe it is important that final recommendations capture the following key points:

- **Scope** - In developing recommendations to address potential risks arising from securities lending and repo activity, care must be taken to ensure that proposed remedies are appropriate for credit institutions which are already captured within the scope of the Basel III regulations. Duplication or conflict must be avoided and the scope of application of the proposed recommendations needs to be carefully tailored.

- **Overlap** - Significant work has been advanced in recent years by the Basel Committee to strengthen liquidity and ensure prudent balance sheet risk management within banks. For instance, the Liquidity Coverage Ratio (LCR) accounts for secured lending and repo transactions by ensuring outflows related to these transactions, during a stressed period, are adequately covered by a stock of liquid assets. The proposal to implement mandatory minimum haircuts could lead to significant overlap in this area. Furthermore, the Basel III Leverage Ratio places a limit on banks' balance sheets, directly affecting the extent to which secured borrowing can be undertaken. These rules should not be unnecessarily undermined or duplicated by additional measures designed to address the non-bank sector.

Chairman of the Supervisory Board: Paul Achleitner
Management Board: Jürgen Fitschen (Co-Chairman), Anshuman Jain (Co-Chairman), Stephan Leithner, Stuart Lewis, Stefan Krause, Rainer Neske, Henry Ritchotte
Deutsche Bank Aktiengesellschaft domiciled in Frankfurt am Main; HRB No 30 000, Frankfurt am Main, Local Court; VAT ID No DE114103379; www.db.com



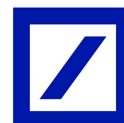
- **Transparency** - We believe that a better understanding of existing interactions within securities financing markets is essential to inform the more detailed work that is required to finalise recommendations in this area. The FSB is right to point out that a number of global reporting initiatives have already been launched, and any further initiatives in this space should take these into account.

- **Consistent implementation** - Global implementation of the FSB's final recommendations will be essential if they are to be effective in reducing system-wide risks. It is therefore critical that the FSB focuses explicitly on the approach to implementation and ongoing oversight of the application of new rules at this stage. We also have concerns that rules are being developed based on the current environment, without fully determining or understanding how the landscape will change in two to three years' time as a result of other regulations (i.e. Basel III, CRD IV and EMIR in the EU, Dodd Frank in the US and forthcoming proposals in relation to the collateralisation of non-centrally cleared derivatives for all market participants) which will rely heavily on participants' ability to finance their positions and significantly affect collateral flows globally. It may be prudent therefore to consider implementation timeframes and monitor this area of focus before applying strict rules.

We would be very happy to discuss any of the points raised in this response, or to provide additional information if it would be useful.

Yours sincerely,

Andrew Procter
Global Head of Compliance, Government and
Regulatory Affairs



<u>Deutsche Bank response to the Financial Stability Board's consultation on Strengthening Oversight and Regulation of Shadow Banking Policy: a Framework for Addressing Shadow Banking Risks in Securities Lending and Repos</u>.

A. General remarks

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.

This consultation, along with the FSB's interim report on securities lending and repo, effectively identifies the potential financial stability risks that could arise from these activities. However, many of these risks will be mitigated by the implementation of the Basel III framework.

For instance, the introduction of the Leverage Ratio will significantly curtail the extent to which banks can raise funding against assets, whilst the Liquidity Coverage Ratio (LCR) will ensure that banks hold a sufficient quantity of liquid assets against a potential loss of secured funding during a severe stress scenario. These are developments which will have a clear bearing on the risks that the FSB is seeking to tackle through this paper and as such it is important that they are properly reflected in the final recommendations of the FSB - particularly with respect to determining the scope of application for the proposals.

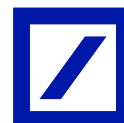
Care should also be taken not to create disincentives for secured funding with the introduction of mandatory minimum haircuts. This recommendation, when coupled with the Basel III LCR which already stresses outflows on secured funding transactions, could remove the benefit of secured funding and lead to a higher reliance on unsecured money.

Finally, the risk that maturity transformation brings for regulated entities is fully captured within the Liquidity Coverage Ratio (LCR) and will be strengthened by the Net Stable Funding Ratio (NSFR) when it is introduced. Therefore attempts to impose limitations on maturity mismatch, outside of this context, would risk duplication.

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?

We endorse the overall approach of the FSB which has tried to maintain focus on tailored and proportionate interventions to address risks where appropriate. For the most part specific recommendations meet the test of proportionality; however, we do not believe that this is the case for those relating to mandatory minimum haircuts.

We do not believe that the measures proposed around minimum haircuts would be effective in reducing pro-cyclicality and have concerns that they could have significant unintended consequences. They would also duplicate market risk measures in Basel 2.5 and Basel III, which could in turn lead to perverse incentives that would undermine the overarching financial stability aims of the FSB framework. In addition, the cumulative impact when combined with other regulatory proposals should be considered. In particular, the Basel Committee and



IOSCO are currently developing proposals regarding the collateralisation of non-centrally cleared derivatives and whether re-hypothecation of that collateral would be possible. It is important that the implications of these proposals are taken into account in the FSB's final recommendations for securities lending and repo.

More generally, as stated above, we also believe that many of the key risks identified by the FSB are already captured or addressed under capital, liquidity and leverage rules being applied to banks. This should be taken into account in the FSB's final recommendations. For example, restrictions on leverage for regulated entities will be captured under the Basel III international Leverage Ratio. Repo and secured lending are captured within the exposure measure calculation of the proposed Leverage Ratio and collateral price volatility is captured within LCR-prescribed repo haircuts. If the intention is to further capture system leverage rather than institution-specific leverage, the FSB should also take into account that many institutions will be required to hold systemic risk buffers either as global or domestic Systemically Important Financial Institutions, which is a further protection and disincentive against inter-connectedness.

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?

Enhanced monitoring of financial stability risks - for all market participants whether prudentially regulated banks or non-banks - is essential to provide an understanding of where risks lie and to be able to develop appropriate regulatory responses to them. Greater transparency will inform regulation and should be prioritised in order to ensure the FSB's view on the precise regulatory tools that are required to address the risks identified are appropriate. Without current data on the functioning of the market, effective impact assessments for individual measures will be impossible to complete.

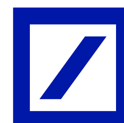
Many of the key data elements are already available to supervisory authorities in a number of jurisdictions. As far as possible these existing data initiatives should form the basis of proposals for enhanced data collection and the FSB's recommendations should focus on ensuring as much global consistency in data requirements as possible.

The regulatory reform agenda that is already being delivered will address many of the risks identified by the FSB analysis (i.e. greater transparency via OTC reforms globally; UCITS and MiFID revisions in the EU; liquidity, leverage and capital rules and large exposure limits designed to capture non-banking entities under the revised Basel framework). The FSB's overall approach to regulation of the repo and securities lending sector has quite rightly focussed on the need to ensure proportionality. Ensuring the appropriate scope of application for recommendations should be an essential element of that proportionality.

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.

In our view, the introduction of numerical floors for haircuts on securities against cash transactions would have the unintended consequence of incentivising unsecured funding and/or use of lower quality collateral. Specifically, we think:

- The proposals are out of line with Basel III LCR haircuts i.e. 4% for longer-dated sovereign debt securities vs 0% in the LCR.



- Imposing floors which are higher than those used in normal market practice could introduce incentives for less vigilant collateral management i.e. two sovereign debt securities are both subject to a 4% floor; one security is issued by a more highly rated sovereign than the other, and therefore receives a low haircut in normal times. If both are subject to a 4% floor, collateral managers are in turn dis-incentivised from utilising the higher quality collateral.
- Where floors conflict with those prescribed in the LCR, there will be a net benefit under the LCR for holding the collateral instead of using it in repo markets. For example, if you hold an unencumbered level 1 asset you can count 100% of its value in the liquidity buffer. Alternatively, if you repo that security you will only receive the post-haircut value in cash. Hence, for LCR compliance, it would be advantageous to fund your position unsecured if a mandatory haircut is applied.

In this context, we support the FSB's intention to carry out a Quantitative Impact Study on these proposals which we believe will demonstrate that minimum haircuts would be counterproductive. When assessing the impact of mandatory minimum haircuts on the regulated banking sector, the FSB should consider the combined impact of these proposals with the Basel III rules on both leverage and liquidity. In addition, the FSB should consider the impact assessment conducted by the Basel Committee and IOSCO when developing proposals for collateralisation of non-cleared derivatives. This will result in significant changes to the availability and use of collateral globally.

Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately)

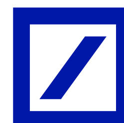
In light of the potential for many of the recommendations set out by the FSB to have significant unintended consequences for financial markets, it is imperative that any regulatory initiatives are preceded by a thorough impact assessment and subject to phase-in - as the FSB suggests. If recommendations are taken forward on minimum haircuts, limits on cash collateral reinvestment and re-hypothecation of client assets, then we would recommend the FSB incorporates a "monitoring period" to assess the impacts, similar to the approach used in updating the Basel framework. Such a monitoring period would be all the more important given the interaction of recommendations with other regulations still to come into force, such as Basel III and Basel Committee/IOSCO proposals on margin for non-cleared derivatives.

Consistent global implementation of any rules is also essential and as such we welcome FSB leadership in this area and would emphasise the importance of the FSB continuing to be closely focused on the implementation of any final recommendations in this area.

B. Transparency

Overall we agree with the assessment that regulators globally need access to more consistent and granular data on securities lending and repos. We believe that a significant amount of data is already being provided to individual supervisors and strongly endorse the FSB's recommendation that the first step to improved transparency should be to build on existing sources of data.

We also welcome the recognition that, to be useful, different levels of data are required for different purposes. It is essential that any data collected should be directly relevant to providing supervisors with a better understanding of specific potential risks arising from securities lending and repo activity. Steps to improve data collection should focus on improving existing sources to allow detection of potential systemic risk and relevant data gaps. If essential, yet currently uncollected data is identified, relevant contractual-level data can then be requested. However, it



may be that in most instances aggregated, or information on net positions, will suffice. These additional items should be requested with adequate time for banks to adjust their systems. This point is particularly significant in light of European firms who are currently implementing substantial new reporting requirements (COREP and FINREP).

A significant amount of information on institutions' credit risk exposures through repos and securities financing is already included in banks' Pillar 3 disclosure reports under Basel III. The Basel III Quantitative Impact Study is another important source of data, collecting information on banks' maturity transformation (Net Stable Funding Ratio) and secured lending activity (Liquidity Coverage Ratio) plus applied haircuts.

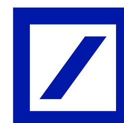
In addition, a number of national regulatory reports and market surveys already capture much of the data that the FSB indicates may be required to provide the required level of transparency. The consistency and comparability of this information should be reviewed along with any gaps for the purposes of detecting emerging systemic risks. Existing sources include: the International Capital Markets Association's European Repo Council's biannual survey; the Bank of England's quarterly money market survey; reports generated for clients under the UK Financial Services Authority Client Assets sourcebook regime; and the FSA hedge fund survey.

The FSB considers that the time lag and granularity around regulatory reporting and surveys is a downside to relying solely on these tools. However, before proposing entirely new frameworks for collecting data, the scope for reducing time lags or extracting more data from existing reports in a cost efficient manner should be fully explored. For example, inclusion of monthly delta changes alongside existing reports would identify increases in collateral transactions which could indicate an increase in leverage, without a need for significant new data fields to be added.

Q6. Do you agree with the information items listed in box 1 (see annex) for enhancing transparency in securities lending and repo markets? Which of the information items are already publicly available for all market participants and from which sources? Would collecting or providing any of the information items listed 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 do not believe that the list of data items proposed by the FSB in Box 1 would present significant practical problems for DB to deliver, though this in part reflects the fact that a significant proportion of the items are already required as part of existing regulatory reports or surveys. To the extent that more granular or frequent data is required by the FSB or there is an explicit need for additional data items to be captured, then there will be associated system costs for market participants to deliver them. As such, it will be important to ensure that all items requested are necessary, as relevant for the detection of emerging systemic risk, and are not already being captured through other means. The benefits of increased granularity must be weighed against the costs of collection - not just for market participants, but also for supervisors who will have to absorb and interpret data flows.

Where it is concluded that data fields over and above those currently captured by reporting requirements or surveys across jurisdictions are needed, then the FSB should ensure that appropriate phasing of implementation is in place to avoid any sudden spikes in systems costs and to allow firms to manage implementation projects appropriately. This would ultimately ensure a greater degree of accuracy in the data collected.



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?

We would agree that a Trade Repository(ies) (TR) may ultimately be the most effective way to collect comprehensive market data on sec lending and repo activity and overall would be supportive of this approach, as long as there is scope for market participants to shape the number and nature of the TRs created (i.e. there should be flexibility for firms to determine the most effective way of delivering and verifying the accuracy of the required trade data).

The logistical requirements of establishing a TR must be carefully thought through. While not all regulators currently receive detailed transaction-level data it is available in many cases. As mentioned in response to previous questions, the FSB is therefore right to recommend that further study and interim steps are needed to determine feasibility and cost before proceeding with a TR. For example, the gains from improvements in data collection discussed above should be fully explored alongside assessing the costs and feasibility of establishing TRs.

We agree with the FSB's assessment that global TRs for securities lending are preferable and believe that repo TRs should also be considered on a regional or an international basis. In order to be viable, TRs need to have a critical mass and in some currencies repo markets may not be sufficiently large to sustain this. As such, factors such as the size of the market, scope for co-location with complementary markets and the opportunity to exploit existing platforms for other products should be considered when determining the appropriate level for a repo TR. Market participants will be best placed to answer many of these questions about optimal scope and product reach for individual TRs and as such it is important that firms themselves are closely involved in the development of TRs.

It is also important that commercial sensitivities, confidentiality and information security are properly respected in the establishment of a TR. While there are strong arguments for a wide range of data to be available to supervisors, it does not automatically follow that it would be beneficial to make all of this information publicly available.

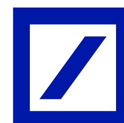
Consideration should also be given to the use of service providers who provide outsourcing services (such as fund management and agency securities lending) to market participants and could perform reporting on behalf of the underlying entity.

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?

From market participants' experience of the move to central TRs for OTC derivatives, several lessons must be learned.

First, TRs should be global where possible and organised more regionally/nationally depending on the size and nature of the product market. As outlined above, this will vary by market and will also depend on the scope for co-location with other markets or existing platforms. The location of TRs will also affect implementation around data collection - as trading happens globally and spans different time-zones - and delivery dates. The legal framework under which the TR operates should also be considered, as some jurisdictions have very stringent rules around outsourcing usage, data security and privacy of information. This should not impede regulatory access. To ensure global comparability of data, fields and formats of data collected should be consistent with the FSB Legal Entity Identifier initiative.

Second, the purpose of collecting that data and who would have access to it must be clearly defined up front. A clear purpose will help determine what scope, in terms of products covered



and information provided, would be most relevant and appropriate to report. While regulators should be able to have access to that information - providing they follow confidentiality rules around information exchange - the FSB rightly recognises that public information would have to be an aggregated (and anonymised) subset of that submitted and available to regulators. It should also be clarified what action could be taken by a regulator and under what terms, based on the information collected. In addition to respecting confidentiality, stringent information security at every stage of the handling process is needed and should be reflected in choice of provider, warehousing, technology used and process for maintaining and receiving information. This will carry significant costs but is essential given the highly commercially sensitive nature of the information.

Third, the terms under which the TR can collect, use or share that data should be made public and should be based on the premise of objective, non-discriminatory access and pricing. Service providers, including from within the TR's parent company, should only have access to the information maintained by the TR when the relevant counterparties have provided their consent. That said, the legal framework applying to the TR should be considered with regards to confidentiality and data security - as some jurisdictions have very stringent rules in place that may prevent legitimate regulatory access and outsourcing arrangements.

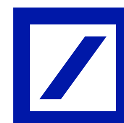
Fourth, consideration needs to be given to which products and what data it is necessary and relevant to report to the TR, the volume of information to be provided (e.g. many repo transactions have maturities of less than one day and as such, could significantly add to the volume of data without significantly enhancing its relevance for systemic risk purposes) and the timing in which it must be supplied. For instance, it would not be practical to require any data delivery prior to T+1. The need for timeliness must be balanced against the requirement for data accuracy. In addition, early thought should be given to how to ensure consistent formatting and prevent duplication of reporting. In our experience, it has proved complicated to integrate into existing internal systems the ability to 'replay' or correct/amend information in the TR and for the TR to confirm the receipt and accuracy of the amendment.

Finally, and most importantly, assessments of cost and feasibility need to ensure that existing platforms are fully explored and an appropriate timeframe for implementation is assessed based on the feasibility of adapting these or setting up new platforms. Interim improvements in data collection should be pursued before setting up new TRs, which should have a long lead-in time to allow all the issues of implementation outlined above to be thoroughly considered.

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.

Global harmonisation around the rules regarding public disclosure would be beneficial. Publicly reported information can be more relevant than just notional transaction data, for example, capital allocation reporting under Basel III. In addition, under Pillar 3, banks already report their credit risk exposure through repos and other securities financing transactions in a detailed breakdown by industry, country, and maturity. Other financial market participants should be encouraged to do the same.

In addition, the recently concluded work of the FSB Enhanced Risk Disclosure Task Force goes some way to closing the data gaps identified in this report. For example, it recommended that participating banks provide greater detail on sources and use of collateral and on asset encumbrance, including collateral received that can be re-hypothecated. Participating banks will implement these enhanced disclosures in their 2012 financial year reports.



Public disclosure may not be appropriate for some of the data items list; care would need to be taken to ensure that the definitions of items to be disclosed were clear to avoid any confusion or erroneous reporting. In particular, we would suggest that very careful thought would need to be applied to the definition of trading on own account. This might be done relatively simply by requiring disclosure of aggregate re-hypothecated assets against aggregate client indebtedness across a firm. If the first of these is lower that the latter, it will be clear that the re-hypothecation of collateral has only been carried out to fund client activity.

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 these items would be useful for investors and would not foresee significant practical problems reporting them, though with the same caveat above around consistent definition of items to be disclosed.

In the EU, new disclosure requirements have recently been introduced for UCITS and UCITS ETFs that use efficient portfolio management techniques, which cover much of this ground including: the intention to use such techniques; the risks arising; the counterparties; type of collateral received; revenues received and operational costs. These will take effect early in 2013 and existing funds will have 12 months to become compliant.

C. Minimum haircuts

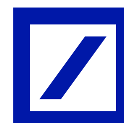
DB does not support the use of mandatory minimum haircuts as a tool to limit the build up of excessive leverage or reduce pro-cyclicality in the financial system. We do not believe that minimum haircuts will be effective in tackling the stability risks identified by FSB, and can see clear risks attached to their introduction.

First, it is unclear the extent to which haircuts would ever be an effective tool in reducing the risk of a ‘run on repo’ identified in the recent financial crisis. These occurred as a result of sudden changes in market sentiment driven by a complex range of factors and were limited to a specific asset class and the US market[1]. The role which minimum haircuts would play in preventing a repeat of such a scenario is not obvious - certainly not when placed alongside other regulatory interventions designed to target capital, liquidity and leverage directly.

Secondly, the introduction of minimum haircuts would limit market indicators of stress. A haircut widening signifies a loss of confidence in: i) a counterparty’s ability to repay; and ii) the availability of liquidity within the market. Installing hard mandatory minimums would blunt or even remove this important early warning indicator, which is a crucial tool for financial institutions and regulators alike. Minimum haircuts would also increase the credit exposure of borrowers, which could aggravate system risks in stress situations.

Finally, a significant unintended consequence of this measure would be that any transactions taking place below the haircut floor in both the repo and secondary markets would be lost. This would have a directly opposite effect to other regulatory initiatives, which attempt to promote and sustain the health of the secured financing market. Furthermore, increasing the cost of secured financing in relation to the alternative (i.e. unsecured lending transactions) could have perverse effects.

[1] See Richard Comotto, European Repo Council



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?

Although we agree with the sentiment of introducing consistency to the calculation of haircuts within the sec lending and repo markets, the proposed methodology of using the long-run maximum expected decline in the market price of the collateral, calibrated at the 95% confidence level, could be significantly problematic.

The haircut an institution employs is a product of two factors: price volatility and counterparty risk. Though the second part of section 3.1.2 suggests that other risks should be taking into account where relevant, it is very unclear as to precisely what risks this might include, or how they might be captured alongside the methodology in the first part of 3.1.2.

As drafted, the proposed haircut methodology appears to ignore the second factor above - counterparty risk. However, as historic haircuts would clearly have taken into account counterparty risk alongside collateral price volatility, this could significantly distort future haircut levels. Applying extended haircuts to credit-worthy counterparties on an ongoing basis could result in costly implications for the availability of liquidity to credit-worthy market participants. For example, in Tri-party Repo (where all trades are cleared centrally and the risk of CCP default is extremely low) applying the long-run worst case scenario, which may have been based on non-credit-worthy counterparties, would be unsound.

Furthermore, any institution-specific ‘worst-case’ model which goes beyond the haircuts prescribed in the Basel III Liquidity Coverage Ratio (i.e. standardised haircuts based on predicted worst-case price volatility) could produce significant unintended consequences.

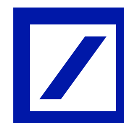
In light of these concerns, we would advocate as an alternative to the proposed standards the creation of a well-developed set of guidelines on the calculation of haircuts for market participants.

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 pro-cyclicality risk? Do the types of securities identified in Options 1 and 2 present a material pro-cyclical risk?

Introducing a framework of numerical floors for the valuation of collateral in securities lending and repo transactions, in the current regulatory setting, may have perverse consequences for the functioning of financial markets.

Secured lending represents a low risk transaction:
Numerical floors or backstops on haircut values, set in contrast to prevailing market rates, would lead to the significant risk that institutions opt to undertake unsecured lending because secured lending and repo is made too costly. This is in stark contrast to the incentives trying to be created by the Basel III regulatory framework.

The haircut value incorporates counterparty risk:
The haircut applied to a secured lending transaction incorporates a number of factors, including counterparty risk. Mandatory minimum levels which are in excess of those used when lending to highly credit-worthy counterparties would eliminate the incentive to lend to credit-worthy customers, and thereby potentially increase systemic risk.



Severe market distortion:
There would be a significant risk that numerical floors become a de facto market standard if set at a backstop level.

Incentivising poor collateral risk management practices:
Imposing numeric haircut floors which are higher than those used in normal market practice could create perverse incentives for firms to take a more relaxed approach to collateral management. For example, of two sovereign debt securities, if one security is issued by a more highly rated sovereign than the other, then it will receive a lower haircut in normal times. If both are subject to a 4% floor, collateral managers will be dis-incentivised from utilising the higher quality collateral, thus undermining risk sensitivity in the market.

High risk of regulatory duplication:
The risks that the proposed numerical floors or backstops intend to allay are already, if not soon to be, extensively mitigated within the regulated banking sector:

I. *Basel III liquidity standard:* The LCR accounts for secured lending and repo transactions by ensuring outflows related to these transactions during a stressed period are adequately covered by a stock of liquid assets. Were these proposed floors to conflict with those prescribed in the LCR, there will be a net benefit for holding the collateral instead of using it in the repo markets. For example, if you hold an unencumbered level 1 asset you can count 100% of its value in the liquidity buffer. Alternatively, if you repo that security you will only receive the post-haircut value in cash. Hence, for LCR compliance, it would be advantageous to fund your position unsecured if a haircut is applied.

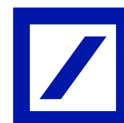
II. *Basle 2.5 and Basel III credit and market risk requirements*: Efficient management should already be ensured for credit institutions through the strengthened counterparty credit risk framework.

III. *Basel II standard supervisory haircuts*: Incentives are already in place to prevent pro-cyclical haircuts, as capital penalties would apply to counterparty risk where haircuts are lower than the Basel II standard supervisory haircuts.

IV. *Ongoing Fundamental Review of the Trading Book*: Market risk requirements will be further strengthened following the review currently being undertaken by the Basel Committee. In fact, banks run very low market risk due to stressed VaR constraints, with the vast bulk of bank inventory being hedged. This, combined with daily margining, means that a haircuts based on price volatility are less relevant than they may have been in the past.

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 pro-cyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

We do not support the introduction of numerical floors or backstops to the haircut value places on an asset used in secured lending or repo transaction. However, if constrained, we would have a clear preference for the backstop option.



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

The FSB must give due consideration to the introduction of the Basel III framework and other pre-existing regulatory proposals which set out to achieve the same outcome as this proposal (see above). In particular, the FSB should carefully analyse the impact of the introduction of the numerical haircut floors coupled with the changes to the regulated banking sector and other changes to the regulation of collateral for all market participants as a result of post-crisis regulation.

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?

We would challenge the proposal that haircut methodologies need to go beyond the Basel 2.5 VaR requirements and Basel III LCR haircuts and question the value of using the long-run maximum expected decline in market price of collateral as the basis of minimum haircut calculations.

Such an approach ignores the fact that banks will already be required to run very low market risk due to stressed VaR constraints, with the vast bulk of bank inventory being hedged. This, combined with daily margining, means that haircuts based on price volatility are less relevant than they may have been in the past. There is risk with this recommendation that haircuts would be set unnecessarily high on the basis of scenarios that existing regulatory reforms will ensure cannot be repeated.

In our view, the most effective way to address the concerns raised in the paper around pro-cyclicality is through ensuring proper risk management and documentation are in place within institutions, whereas imposing numeric haircut floors which are higher than those used in normal market practice could incentivise less robust collateral risk management practices.

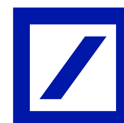
Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality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

We do not support the introduction of numerical floors or backstops to the haircut value places on an asset used in secured financing or repo transaction. Please also see answers above.

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.

As outlined above in response to question 12, we see the implications of minimum haircuts as broad rather than instrument-specific. A detailed impact assessment should be conducted to ensure that impacts on specific instruments are well understood before haircuts are considered.

The FSB paper makes clear that further consultation is intended on the detail of a minimum haircut approach. We think this will be important. Prior to any final recommendation on minimum haircuts, impact analysis should be undertaken to assess the impact on cost of



funding, banks' balance sheets and market liquidity to ensure there are no unintended consequences. This should also take into account the impact of BCBS and IOSCO proposals on margin for non-cleared derivatives. The quantitative implications of a framework of minimum haircuts would need to be fully understood before it was introduced.

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?

The majority of securities lending trades are currently margined at a portfolio level basis. In line with our response above, we question the necessity of minimum haircuts.

D. Cash collateral reinvestment

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?

It is important to be clear about the intended scope of this recommendation. As applied to non-bank securities lenders and their agents, then we would agree that these are sensible standards to propose and are aligned with rules that are already in place in some jurisdictions (i.e. in EU under UCITS regulations).

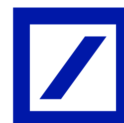
However, were these requirements to be applied to regulated credit institutions, there would be significant overlap with existing regulatory initiatives in this space. For example, the recommendation for a minimum portion of cash collateral to be kept in short-term deposits or short-term highly liquid assets would conflict with the Liquidity Coverage Ratio set out in Basel III - whereby a specific portion of liquid assets is kept to safeguard against collateral valuation changes and haircut widening in a stress scenario.

Imposing limitations on the Weighted Average Maturity (WAM)/Life of the portfolio in which cash collateral is reinvested could have a number of repercussions. For instance, it ignores actual repo market practice where the bulk of assets are funded overnight (particularly in the US Treasury and agencies repo market). There are also a number of technical complications when calculating WAM on a matched book business, including:

- The provision of netting reverses against repos before applying the WAM limit.
- Potential for manipulation by employing one very long-dated trade vs. the bulk in overnight.
- The need to take into account the gross and net repo flows in absolute terms for each tenor e.g. WAM of one day based on an outstanding of €100mn vs. WAM of 30 days based on an outstanding of €100bn.

E. Re-hypothecation

Re-hypothecation of collateral assets is essential to the flow of collateral through the financial system and underpins financing and liquidity of securities markets. By facilitating collateral velocity, there is a link between re-hypothecation and leverage at a systemic level, but any risks arising from this are best addressed by interventions targeting effective liquidity and counterparty risk management (as are already in place for banks), as opposed to direct restrictions -or even blocks - on re-hypothecation. These could have very significant and dramatic consequences for market liquidity, especially if introduced on top of existing regulatory



reforms which will place greater demand and restrictions on collateral, such as margining for non-cleared derivatives. Such approaches would also fly in the face of the wide range of regulatory reforms which are designed to incentivise much greater use of secured financing in financial markets.

Furthermore, the risks associated with collateral re-hypothecation in secured lending and repo transactions only materialise where any orderly wind down of the re-hypothecation chain cannot be achieved. Rather than arbitrarily limit the re-hypothecation of collateral, which would extensively curtail the availability of secured finance within the market by extracting the availability of assets for use, an approach which focuses explicitly on collateral recovery and transaction wind-down should instead be considered. Such approaches should also ensure consistency with the Basel III regulatory framework and ongoing work on Recovery and Resolution.

We welcome the fact that the FSB has recognised the risks associated with heavy-handed interventions and agree that the primary focus must be on ensuring effective disclosure to market participants – who are already much more wary of counterparty and liquidity risk in the wake of the financial crisis.

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

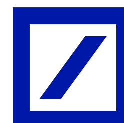
We agree that financial intermediaries should be obliged to provide sufficient information to clients about the re-hypothecation of their assets to ensure that those clients have a reasonable understanding of their potential exposures in event of a failure. However, it is important to note that in most cases (certainly in respect of prime brokerage activity) a client's potential exposure to an intermediary will be clearly established at a contractual level.

When considering an appropriate scope of application of these principles, consideration should also be given to existing limits which regulated institutions are already subject to. For instance, in the US, SEC rule 15c3-3 explicitly limits re-hypothecation of collateral to 140% of the clients' net indebtedness. In other jurisdictions where there is no hard limit, commercial negotiation will determine precise re-hypothecation limits for each client, but it would be rare to see re-hypothecation limits above 140%. Whatever way the limit is determined, the important point is that there is an upfront negotiation which will set the maximum exposure to a broker. Regular reporting of precise exposure / level of collateral re-hypothecation at any given point in time provides further clarity as to exposure. In the UK, for example, disclosure to clients of both the indebtedness calculation and the assets re-hypothecated to fund said indebtedness is already provided on a daily basis, in conjunction with FSA Client Asset (CASS) rules.

Where no beneficial interest is retained in collateral, as in repo transactions where collateral is transferred from one party to another by full title transfer, the disclosure of collateral re-hypothecation is not relevant.

Whilst the principle of requiring that client assets should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary may be attractive, the practical application of such a rule would be very difficult to achieve. As mentioned above, identifying aggregate re-hypothecated assets against aggregate client indebtedness across a firm might be one approach to achieving this aim.

Limiting re-hypothecation to entities which are subject to regulation of liquidity risk is likely to have significant unintended consequences for availability of collateral and market liquidity more broadly. Where there are not currently restrictions (i.e. Europe) such a move could significantly thin the market and reduce the amount of available collateral. A careful assessment of



implications and potential costs alongside other regulatory proposals that will affect the amount of available collateral would be needed before proceeding.

The issue of client asset protection is complicated and would need to be scrutinised in a variety of different contexts - e.g. prudential regulation, insolvency law, reporting etc. An expert group looking at all of these different issues with a view to ensuring greater consistency would be a valuable enterprise.

F. Minimum standards for collateral valuation

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?

We would strongly agree with the proposed minimum standards for valuation and management of collateral by market participants. In our view, these standards represent prudent risk management that should be general market practice.

Whilst it is important that market participants have a clear view of how they would manage the failure of their counterparties, the level of detail and reporting associated with contingency planning should be proportionate (i.e. not overly onerous or costly).

G. Structural aspects of securities financing markets

Q22. Do you agree with the policy recommendations on structural aspects of securities financing markets as described above?

If there is trade reporting and consistent assessment of risks and valuation of collateral, then it is not clear to what extent there would be a benefit from requiring central clearing of repo and securities lending transactions.

This would be a costly exercise which would further tie up collateral. Benefits would be limited and, as has been widely discussed in the context of OTC derivative reforms, the concentration of risk within central counterparty (CCP) infrastructure creates potential new systemic challenges for supervisors. As such, we support the FSB's scepticism about further work in this area at this time. Only once other recommendations have been finalised and effectively implemented and only if there are clear continuing risks identified within the system that cannot otherwise be addressed should a CCP solution be considered. Even then, a rigorous assessment of impacts would need to be the starting point for any discussion.

Whilst we recognise the challenges that would be attendant in trying to deliver changes to bankruptcy law treatment, or the development of Repo Resolution Authorities (RRAs), we do not think they should be dismissed as options entirely at this stage. Consistent bankruptcy law treatment would address persistent concerns from some quarters around perceived risks of re-hypothecation. Insofar as this focused on ensuring improved transparency around outcomes in the event of bankruptcy, to avoid the dramatic market consequences of interventions designed to limit re-hypothecation directly, then this would be a better approach to take.