FEDERATION
BANCAIRE
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FRENCH BANKING FEDERATION RESPONSE
TO THE FINANCIAL STABILITY BOARD CONSULTATION DOCUMENT
FOR THE REGULATION OF SHADOW BANKING RISKS
IN SECURITIES LENDING AND REPOS

The *Fédération Bancaire Française* (the French Banking Federation, hereinafter FBF) is the professional organisation that represents the interests of the banking sector in France. It comprises all of the credit establishments registered as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France, 400,000 employees and 60 million customers.

French banks welcome the initiatives undertaken by the Financial Stability Board (FSB) and the opportunity to contribute to the analysis of the evolution needed to enhance transparency, strengthen regulation of security financing transactions, and improve market structure, regarding Securities lending and Repos. The FBF shares the view that upholding the integrity and credibility of these market activities are key to the industry.

The FSB's public consultation is broad in scope and includes not only potential risks in Securities lending and Repos, but also other specific areas in which FSB believes policies are needed to mitigate the potential systemic risk associated with Shadow banking. The FBF's response focuses on the scope for Securities lending and Repos, as this market represents a key interest for French banks operations in the euro area.

As the professional association of the French banking groups, the FBF represent in the same time the regulated banking universe and some parts of the so-called 'Shadow banking' universe. We hence believe that we can provide standard-setters with a well-grounded analysis of the issues at stake.

Our response is divided in two parts: first of all a few general comments and then some more specific remarks.

General comments

- Following invitations by the FSB to provide comments in respect of their publication, the FBF want to take the opportunity in providing members feedback.

  If there is a growing consensus that supervision and a strengthened regulatory framework is needed to harness the Shadow banking system, it is necessary to **preserve a useful channel of financial intermediation that can provide benefits to the real economy** at a time when bank financing is more constrained. This is all the more true as repos and securities lending activities play a critical role in the transmission of Central Bank monetary policies to all economic players and to the subscription and liquidity of government and corporate debt securities.

- As for this specific consultation on securities lending and repos, we would like to emphasize that **a very large part of this activity takes place between regulated banks and is therefore not connected to the shadow banking system**. Given that both markets operated for many years prior to, and through the financial crisis we believe that greater weight should be given to actual experiences observed as opposed to some of the more theoretical risks. For example, regulation covering minimum levels of haircuts for collateralised transactions, if calibrated incorrectly, could seriously damage markets' sustainability at a time when higher volumes of collateral are expected to be required to support a more sound financial system. Given this **we would suggest as to ensure that securities lending does not give rise to financial stability risk, to focus initially on developing further transparency and disclosure (including for the reinvestment of cash collateral), and the development of some high level principles governing collateral management more broadly.**

- As regards regulation of repo and securities lending activities, **we are in favor of an indirect regulation through the regulation of banks and non-banking financial intermediaries (such as funds) taking part in these activities.** Two dimensions have then to be taken into account:

- Entities being different in their nature and their objectives, there is no one size fits all regulation. In our view, the analysis should focus on the general principle that same functions or same activities must call for equivalent but not identical regulations considering the nature and specificities of the entities, in order to address the same objectives and have the same effects and consequences.

- On the second dimension, it is necessary to take into account the existing or proposed framework implemented for each entity **in a geographical perimeter**. We believe that much has already been done in Europe concerning the banking system as well as the non-banking system. Thus**, we are highly supportive that the FSB focus on potential arbitrage which may exist between identical entities submitted to different jurisdictions.**

  In our opinion, it is fundamental to take into account these two dimensions in order to make sure that new regulations would not be detrimental to the economic growth on behalf of financial stability

- The FBF would like to highlight a number of points relating to the potential changes to the regulation of repos and securities lending.

I. Regarding recommendations related to improvement in transparency

- First of all, the FBF acknowledges **that enhanced transparency through increased reporting obligations would be helpful for regulators and the market**.

  The bulk of such activities being by nature ‘over the counter’, information on volumes, liquidity, etc. even if already disclosed in different ways is not publicly available, which is inconsistent with the importance of the economic and social role of these transactions.

  We hence strongly support any initiative which will contribute to enhancing the transparency of repo and securities lending markets. Reporting to one or a limited number of trade repositories is one of them. Given the number of trades, the structure of such reporting would have to be carefully designed alongside with the industry, in order to allow for speedy and useful reporting, at reasonable costs to all parties.

  However, a careful analysis should be made of the extent of such disclosure, in order to ensure that the value of the information received justifies the cost of extracting it. Hence, this intent to procure transparency should be borne and framed by the following principles:

  - Detailed articulation of the regulatory concern and risk metrics;
  - Clear definition of underlying product scope, agent and transaction perimeter;
  - Reduce redundancy scope by including existing regulatory remits (amongst others Basel III capital and liquidity regulatory guidelines) on both regulated and shadow banking segments activity;
  - Seeking full industry involvement;
  - Leveraging on existing initiatives (ERC/ICMA quarterly survey, Markit efforts);
  - Attempting to calibrate full activity landscape by product type, region and type of agent.

  That being said, **many jurisdictions have a banking secrecy regime and often the repos and securities lending contractual documentation contained provisions regarding confidentiality.** Therefore, in order not to be in breach with those regulations or agreements where firms report transactions, it will be necessary to provide for an exemption in that sense (as exists in EMIR regulation for reporting of derivative transactions).

II. Regarding recommendations related to regulation

- Secondly, the FBF also requests that similar levels of apprehension be applied in respect of other proposals, including **the use of mandatory minimum haircuts**. Its concerns include (amongst others) the fact that **minimum haircuts will extract large volumes of liquidity from the market and may not be successful at preventing further liquidity being withdrawn from the market during a crisis**, since lenders may simply take other action such as reducing existing credit lines.

  For that reason, we have strong reservations in relation to numerical floors to haircuts set by regulation. **Haircuts are part of the trades’ price. Quantifying haircuts should remain the prerogative of the finance industry i.e. market participants**, **whilst regulators should be independently reviewing the applied methodology as to risk assessment practice, governance and application scope**.

A regulator imposing mandatory haircuts is **blurring the separation of duty principle between economic agents and their supervisors**. Finance industry practitioners pride themselves of having established, over the years, a strong credit risk expertise, which would become totally subordinated in the face of mandatorily imposed haircuts. A further danger exists, that mandatorily imposed haircuts might incite to weaken the fiduciary function, as responsibility to discern credit risk would implicitly be shifted to the regulator.

Above all, minimum haircuts may have unintended consequences such as imposing too high exposures of banks to non-banking entities (through equity repo for instance), or freezing government bond liquidity. More generally, **we consider that the imposition of haircuts may introduce elements of administrative control which may hamper the efficiency of the market.**

Finally, haircut dynamics also generate sizeable and immediate impact on unsecured debtors, which could be one of the unintended consequences regulators wish they had avoided, both as a function of market impact and litigation exposure.

- **We agree with the position of the consultation that mandatory central clearing, contrary to derivatives, is not an obvious solution**. In addition to the reasons put forward in the consultation, we would like to stress that the **vast majority of the trades having less than one week maturity, and very often one day, the contribution of central clearing to the mitigation of counterparty risk is questionable.** We therefore suggest that clearing of repo or securities lending does not become mandatory, and suggest letting market participants resort to clearing offers whenever these are competitive and useful.

- The development of Shadow banking regulation is still at an early stage, and most market participants are likely to be affected by such regulation. A consistent definition of "shadow banking" needs to be adopted.

  Any significant variation in the definition or scope of such regulation ultimately applied by different jurisdictions will inevitably lead to uncertainty and disruption, as well as the opportunity for regulatory arbitrage.

<u>Remark</u>: Without any specific mention, in the following pages comments refer to the FSB's Recommendations (and not to Questions).

Specific Comments

Introduction

General questions (Please provide any evidence supportive of your response, including studies or other documentation as necessary)

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.

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?

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?

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.

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)?

- ⇨ **As regard Q1**, see General Comments.

- ⇨ **As regard Q2**, the FBF would like to stress that securities lending and repo by banks and investment <u>firms is already strongly constrained by the existing counterparty risk framework</u>. In particular, these institutions have a strong incentive to limit their exposures to their repo counterparties, which mainly derive from the haircuts measurements. Importantly, the counterparty risk framework will be further enhanced with Basel III, with notably a stress based computation.

  <u>As to liquidity, current Basel III, Liquidity Coverage Ratio regulation captures substantially secured funding activity</u>. Under certain stress conditions, the ability to continue to transact repurchase, reverse repurchase and other securities financing transactions is limited to transactions backed by High Quality Liquid Assets. Furthermore any ensuing liquidity gap needs to be covered by an adequate liquidity buffer.

We would also like to remind you that European UCITS funds are already subject to regulation addressing those issues

- ⇨ **As regard Q5**, we would like to make a general caveat on phase-in. The Basel III precedents show that phasing in often proves to be inoperative: as soon as the future rule is known, covered entities are subject to strong pressure to comply immediately.

1 - Financial stability risks in securities lending and repo markets
(pages 2 - 4)

- ⇨ The <u>FBF would like to moderate the importance given to secured financing as regard procyclicality of system leverage</u>: indeed cash raised with repo (e.g. equity repo) varies with the value of the security, but whenever the purpose of the repo is to finance the holding of the security, it doesn't matter in terms of funding procyclicality.

2 - Policy recommendations related to improvement in transparency
(pages 4 - 11)

- **2.1 Improvement in regulatory reporting** (pages 4 - 5)

> ***Recommendation 1****: Authorities should collect more granular data on securities lending and repo exposures amongst large international financial institutions with high urgency. Such efforts should to the maximum possible extent leverage existing international initiatives such as the FSB Data Gaps Group, taking into account the enhancements suggested by the Workstream.*

- ⇨ Yes, provided that relevant entities may be exempted from any further reporting and specific monitoring as long as their relevant activities do not exceed a threshold or are not of a nature that constitutes any Shadow banking. In any case, it should be efficient and not result in a burdensome and expensive obligation relative to the expected results.

We believe that <u>an effective, calibrated and focused monitoring should permit a consistent basis for potential regulatory action</u>.

For many years, large European banks provide OTC securities lending and repo data to the ERC (European Repo Council): it could serve use as an additional source, along with seeking alignment with/tie-in with this existing initiative (ICMA quarterly survey). Also it would be very useful to extract the same data when these transactions are cleared through international CCPs.

Additionally, large institutions, intervening on securities lending and repo markets, could be asked to contribute to make volumes traded with international banking institutions more transparent.

- **2.2 Improvement in market transparency** (pages 5 - 9)

***Recommendation 2**: Trade repositories (TRs) are likely to be the most effective way to collect comprehensive repo and securities lending market data. The FSB should consult on the appropriate geographical and product scope of such TRs. The FSB should encourage national/regional authorities to undertake feasibility studies for the establishment of TRs for individual repo and securities lending markets, as well as coordinate and facilitate those efforts. Depending on the consultation findings on the appropriate geographical and product scope of TRs, the FSB should establish a working group to identify the appropriate scope and undertake a feasibility study for one or more TRs at a global level. Such feasibility studies should involve market participants.*

⇨ The main issue is to control systemic risk to ensure financial stability. That control presupposes identifying activities at risk and then regulating the entities providing them. In terms of financial stability, transparency is critical. This transparency may include trade repositories for repos and securities lending/borrowing. In order to avoid being simply a collection of data, but rather information, reporting should be well targeted, using practices and requirements of the management universe.

There is a broad agreement amongst members that transparency should be enhanced with a view to improve supervision and market discipline. Data collection is seen as a prerequisite for a better understanding of activities and their implications in order to facilitate monitoring solutions, which would allow for better targeted interventions.

The belief that the level of transparency within the market is low, whilst it also aids leveraging of positions, is partly unfounded. Firstly for over one decade the ERC/ICMA have been publishing bi-annual surveys, showing the volume of activity across all different areas of the funding market. There is however a major part of the market which is transacting to cover market makers shorts, borrow secured cash from Money Markets funds, two way flows with central banks, intra-dealer repo market making flow. All of this has very little to do with the leveraged community.

- **Regarding Trade Repositories**

The easiest way to get the level of information required, if current surveys do not suffice, is to move forward with some kind of Trade Repositories (TRs). Therefore the FBF agrees with this recommendation but only after standardization of terminology and valuation methodology has been achieved.

Some countries, through national central banks or other institutions, collect already domestic traded transactions data in some securities. In these conditions, existing flows of data should be used and capitalised as much as possible to avoid duplication of reporting and costs.

Consideration should also be given on how to integrate nationally collected data into large, cross-border TRs, prior to set up of such cross-border entities in order to minimize expenditure. Some members recommend avoiding imposing entities report cross-border transactions to multiple regulators or trade repositories. Therefore, it is necessary to organize the sharing of information between regulators and/or provide a global repository trade or a few regional TRs.

Leveraging on derivatives TRs could also be an option provided that specificities of securities lending and repo transactions are appropriately taken into consideration.

Regarding implementation process, an option could be to stagger the reporting device. As a first step the obligation should only concern standard operations for which the requested information is easily identifiable and accessible to trade repositories. More structured transactions would be reported in a second time. Indeed, the experience on derivatives illustrates that management of complex operations by the repositories was far from straightforward and that a certain period of time was required for the development of tools for the communication relating to complex operations.

Recommendation 3*: As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such market-wide surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.*

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.

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?

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?

- ⇨ The FBF agrees with this recommendation. We support the introduction of TRs: they are the best way to get the information whatever the entity, or its regulation, is. However <u>we would like to draw your attention on the cost and time required for implementation</u>: they may make this a difficult task. Therefore it needs to be very clear exactly what level of information is required.

  First there needs to be clear goal as to which data are required and whether they will be really useful for regulators. For instance the repo market is massive, with substantial volumes and with the vast majority of transactions with maturities shorter than one week. To know about thousands of Bund trades in spot/next, is this information really useful?

  <u>Transparency is important but too much scrutinize information to be trawled through may end up being more of a hindrance than enhancing transparency</u>.

  Transactions do not give a clear idea of what an exposure is. They are not an exposure's assessment. <u>We advise to work on defining accurate metrics to be reported to regulators as opposed to exhaustive list of transactions which wouldn't be exploitable by regulators or could lead to misunderstanding on bank's positions.</u>

It is also important that there are no geographical loopholes or difference in treatment, thus causing potential arbitrage. What if a European bank borrows USTs financed with JGBs or Gilts vs US mortgages?

Regarding details of data to be transmitted for Securities Lending transactions, we do not see how transaction level data (iv) (i.e. securities lending fee or rate) and firm-level data (vii) (i.e. breakdown of fee and cash reinvestment return) would assist in adding transparency to the market. In these conditions we consider that those data should not be included in the list of information to be reported to TRs.

We suggest that the industry is highly involved in any analysis / study conducted to identify which types of information should be sent to a TR and on which frequency. In any case, a transversal and harmonised approach should be adopted to avoid any regulatory arbitrage from one jurisdiction to another. It is also worth to note that a significant amount of data is already provided by most market participants on securities lending and repos operations (mainly to clients and data service providers). Existing data sets should be used as far as possible to avoid re-creation of all processes and consequently ensure the adoption of most cost effective and efficient measures.

Alignment and rationalisation should be sought with (regulatory and central bank) authorities as many surveys are already in circulation, asking often very similar data and magnitudes. Rationalisation of these efforts would alleviate reporting burden upon banks, as the latter cope already disproportionately with ad-hoc, regulatory reporting.

In addition we also agree with any interim solution that would consist in reporting measures (e.g. official survey). The implication of the industry is also required on this part.

- **2.3 Improvement in corporate disclosures** (pages 9 - 10)

Recommendation 4*: The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities as needed, taking into consideration the items noted above.*

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.

⇨ The FBF is skeptical about financial statements adding per se any useful information in relation to repos and securities lending. What matters is not the quantity of information provided but the way this information is structured and the value it adds. Of course, its depth should be differentiated according to the need (authorities' vs market participants). A differentiated approach might aim both to be more pertinent and to be non-additive to existing disclosure.

Specifically as to regulatory disclosure, it should be noted that regulated banks provide already a lot of information in terms of balance sheet and funding regulatory ratios.

As regard European UCITS funds, considering the requirements for the KIID (Key Investor Information Document), the prospectus and the annual report, we do not see the added value of more frequent or more detailed disclosure of the identity of the counterparties or more details on the efficient portfolio management transactions.

- **2.4 Improvement in reporting by fund managers to end-investors** (pages 10 - 11)

Recommendation 5*: Authorities should review reporting requirements for fund managers to end-investors in line with the proposal by the Workstream.*

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.

Please refer to Q9.

3 - Policy recommendations related to regulation

(pages 11 - 24)

- **3.1 Minimum haircuts** (pages 11 - 19)

Recommendation 6*: Regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral haircuts. Those guidelines should seek to minimise the extent to which these methodologies are pro-cyclical. Standard setters (e.g. BCBS) should review existing regulatory requirements for the calculation of collateral haircuts in line with this recommendation.*

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?

⇨ The FBF wishes to remind the important role played by the Securities lending and Repos markets in the financing of financial institutions or the procedures of refinancing with the European Central Bank (ECB).

For the FBF, collateral management will become the cornerstone of risk management in the new regulatory framework, along with an increased global demand for highly liquid securities that must meet demanding eligibility criteria. The main driver of this evolution is the now mandatory central clearing of standardized OTC derivatives. The functioning of this market is an essential element in this context.

For that reason, the FBF supports that further research and analysis is undertaken before anything is implemented as the possibility of disrupting market activity is significant. We believe that more detailed consideration is needed before policies can be defined for minimum haircuts.

The FBF has strong reservations against minimum haircuts being set by regulations as this measure is not in line with the market development and could be strongly counter-productive. FBF suggests using other tools in order to avoid excessive leverage for non-banking institutions, mainly through monitoring the system's exposure to non-regulated institutions.

A securities financing transaction needs to be analysed from the point of view of both parties. In case of a counterparty default, the main risk is the difference between the value of the collateral on both sides of the transaction (i.e. cash vs. securities or securities vs. other securities) – known as "gap risk". In a classic repurchase transaction (cash collateralized by securities), the lender of cash will be at risk in case of the decrease of value of the securities, while the borrower of cash will be at risk in case of increase of value of the securities.

This risk is dependent on several factors: mainly the credit quality of the collateral and the correlation between it and the credit quality of the transaction counterparty. The correlation could be strongly positive in case of pro-cyclic systemic risk on some assets, but it could also be negative in case of securities financing on government bonds due to "flight to quality" phenomenon, thus leading to market practices of negative haircuts on some transactions.

⇨ The gap risk can be managed either inside the securities financing transaction itself: haircut, portfolio diversification, eligibility guidelines, rating and spread triggers, regular revalorisations and margining (in some cases, allowing a quasi-real-time valuation of assets in triparty deals) or separately, by classic dynamic credit risk and correlation hedging tools, while integrating the risk hedging cost in the price of the securities financing transaction.

⇨ It needs to be noted that applying haircut on collateral is a measure that creates asymmetry in terms of risk exposure in favour of one of the parties: while it reduces the risk for the party, receiving the haircut, it increases the risk for the other party. Thus, introducing minimum haircut standards for transactions involving regulated entities might lead to transfer of systemic risk to other parties instead of decreasing it.

⇨ Haircuts are agreed bilaterally by the parties to the transaction based on risk expertise of the financial industry. They depend on the nature and risk profile of each counterparty, the risk and liquidity profiles of the underlying, the terms of the trade (e.g. maturity), market conditions and the context or purpose of the trade. Regulation should not interfere with such multi-pronged risk assessment by the market. Besides it should be noted that all banks subject to Basel III will face additional capital charges.

Imposing minimum haircuts to non-banking institutions (i.e. haircuts in favour of regulated institutions) will limit the banks' ability to refinance themselves and their clients, because it will both reduce the ability of certain institutions to lend money to banks and the banks' ability to generate revenue by taking and managing counterparty risks under these transactions.

⇨ **Regarding calculation process:**

One of the main reasons put forward by the FSB for the establishment of numerical haircut floors is to limit the leverage risks. In the same way that prudential rules already imposed on some European investors (French UCITS...), the FBF believe that it would probably be more effective to rule on the funds themselves by setting maximum thresholds of implementation repo / securities lending (% of assets) instead of systematically impose haircuts, imbalances in terms of risk factor.

There are a number of issues with the proposed implementation of a methodology to calculate haircuts which also need to be considered including:

- Whether the requirement should apply to all activity or just financing transactions (as with numerical floors)
- Whether the requirement should apply to all participants or a sub-set (as with numerical floors)
- Inclusion of counterparty quality as a factor in the methodology

1. Care needs to be taken that the methodology does not conflict or disrupt the lending markets where beneficial owners require haircuts in order to continue activity.

2. It should be noted that all banks subject to Basel III will be subject to capital charges already if haircuts are not taken and appropriate. We thus have strong doubts in relation to the fundamental assumption that such a regulation is needed to avoid build-up of excessive leverage. Regulated lenders are already subject to regulatory constraints, such as capital for counterparty risk for banks, which ensure that these entities may only provide other entities with a limited secured leverage.

⇨ **Haircut regulation can be potentially counter-productive**

The FBF want to stress that unadapted regulation on haircuts may be potentially counter-productive:

- <u>Dynamic of repos/securities lending haircuts is not only asset specific but also counterparty specific and maturity specific: it is part of Financial Institutions' risk management</u>;
- <u>Any regulation which would lead to a more standardised approach could benefit to institutions with poorer risk policies, and generally would not encourage institutions from maintaining appropriate risk assessment systems and procedures.</u>
- <u>Any regulation which requires an increase of haircuts has negative impacts on unsecured debt holders of financial institutions</u> (including clients). Weakening unsecured senior debt holder for strengthening Financial Institutions interbank counterparties (which are already secured by underlying collateral) can have significant impact on the unsecured funding market.
- Most importantly, high haircuts would massively increase exposure of banks or investment firms to their repo counterparties. In particular, by forcing banks to take on more credit risk on the counterparties of their repos, such a measure would increase systemicness (see above).

- In relation to recommendation 6, we remind here the point made above: not all securities lending and repo transactions are pro-cyclical. Hence increasing or constraining haircuts for ungrounded procyclicality concerns may be outweighed by the points made in our previous paragraph.

- In addition we suggest that correlation between loan and collateral should also be explored and that proposed parameters are reduced where there is a strong correlation between assets.

- Finally, such minimum standards will often be redundant with existing regulation. Even the so-called ‘other risk considerations’ of section 3.1.2 (ii) are already captured in many instances. For instance, wrong-way risk is already part of the counterparty risk framework of credit institutions. We therefore believe it would be inappropriate to introduce such redundant standards with regulated entities such as banks or UCITS[1].

Recommendation 7*: In principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets. The FSB should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives. This would include consultation on the levels and the scope of application of such framework by counterparty, collateral, and transaction type (see sections 3.1.4 - 3.1.5).*

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?

[1] UCITS have in place a clear haircut policy adapted to each class of assets received as collateral. When devising their haircut policy, UCITS takes into account the characteristics of the assets such as the credit standing or the price volatility, as well as the outcome of the stress tests. This policy is documented and justifies each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets. See box 1.

⇨ The FBF have strong reservations against minimum haircuts being set by regulations. Haircuts are agreed by the parties to the transaction. They depend on the nature and risk profile of each counterparty, the risk and liquidity profiles of the underlying, the terms of the trade (e.g. maturity), market conditions and the context or purpose of the trade. Regulation should not interfere with such multi-pronged risk assessment by the market.

⇨ **Numerical haircut floors may have the following unintended consequences**

- In the banking industry, a repo is today analysed based on the counterparty risk which mainly takes into account the underlying security, the creditworthiness of the counterparty and the terms of the trade; in specific instances, other parameters such as wrong-way risk are also captured. If haircuts are fixed, parties will not be risk sensitive anymore. Therefore there is a risk that minimum haircuts become the standards in the market and that consequently no relevant analysis be further conducted by market participants to assess the risk of each counterparty and transaction;
- Furthermore, the simplicity of the proposed table may create distortions in markets (bucketing approach and updating frequency creating mechanical incentives) and consequent pressure to move to a more granular and complex approach in the best case and in the worst case a new source of systemic crisis.

⇨ **Numerical haircut floors would also raise the following difficulties**

- Level of haircuts should also depend on the maturity of the trade.
- Given the worldwide nature of the security lending and repo markets, any floors would need regulators coordination across both sectors (banks, funds, insurance…) and jurisdictions, not mentioning the non-regulated segment.
- We would also like to stress that the identification of financing transactions is not feasible as such by lenders. In addition, in some cases the purpose of a security transaction may be a combination of short covering and financing.
- Haircuts would have to take into account the relative risk profiles of both parties, as the most creditworthy entity shall, as the case may be, be subject to a smaller haircut in order to reduce its exposure to the other party or, benefit from a larger haircut in order to be better protected against it.

Finally, we would like to again stress that Secured Financial Transactions (SFT) are procyclical only if (1) the asset is procyclical and (2) the purpose of the repo funding is not to finance the repo's asset.

Haircuts are part of the price of a transaction. Regulators should review the haircuts methodology and its governance, but not interfere with market influencing variables. The prerogative of haircut setting should remain with the market.

The only advantage of a numerical haircut framework would be to end up with a transparent market standard that is adhered to by everyone. However, as recent past showed, with it a drop in liquidity, especially where the haircuts are highest can be expected[2].

[2] - Indeed every asset has procyclicality built into it these days, as there is a drive for secured funding for everyone. Even in the sovereign world this year, we have seen with a major increase in haircuts, like Italy and Spain earlier this year, follows a lack of liquidity in repo, thus an inability for cash market makers to fund longs, thus a reduction in liquidity in the underlying cash products.

In any case, further analysis/research should be performed before the adoption of final recommendations/measures on haircuts, in liaison with the industry. And we strongly insist on the need for a coordinated implementation of any measure on a worldwide basis.

<u>If we moved towards a framework based haircut schedule</u>, eventually there would be little interaction between model based and framework based haircuts, as framework based would become the market standard rather than undertaking own appropriate counterparty risk analysis.

In turn this would thus reduce liquidity. Indeed, everybody uses their own interpretation of model based haircut practices with all the said criteria taken into account, however there needs to be a level of discretion to allow for strong customer multi product relationships etc.

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?

⇨ <u>We have strong reservations against any numerical haircut floor whatever its design</u> and we don't believe thus that the options listed in question 16 are discriminatory.

If numerical floors would be kept, as often with 'simple but inevitably wrong' methods, shortcuts will be needed. But all parameters listed would have to be taken into account and combined by any method imposing such floors: transaction type (maturity, purpose…), counterparties (including their **relative** creditworthiness), collateral type.

We believe that unintended consequences of numerical haircut floors will be focused on banks and investment firms, and that such unintended consequences are material from a systemic perspective. Also, as stressed above, distinguishing between a financing trade (e.g. bank funds an equity by reporting it) and a securities lending trade (e.g. the bank lending the same equity in response to a client request) is impossible in practice.

<u>Therefore, if numerical haircut floors were kept, we strongly advocate that in addition to the three options contemplated by the FSB, a fourth one be retained: any trade where at least one party is a regulated financial intermediary (investment firm or bank) is exempted from these haircuts, as the regulated party has capital requirements for counterparty risk</u> : first, for its repos, too high haircuts would unduly increase its exposures to its repos counterparties, thus increasing systemic risk ; and

second, for reverse repos and stock borrowing, it has capital requirement to deter it from accepting too low haircuts. Such focused exemption would be straightforward to implement.

- **3.2 Cash collateral reinvestment** (pages 19 - 22)

Recommendation 8: *Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.*

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?

⇨ The FBF agree with this Recommendation, in order to ensure a same level playing field between the banking sector and the so-called "shadow banking" segment.

As suggested in section 3.2.2, Scope of application, such minimum standards on the use of cash collateral by securities lenders would not cover prudentially regulated entities, and in particular, banks and investment firms. However, the members of the FBF also carry other activities, such as fund management, hence the below comments.

Securities lending and Repo operations should be treated in such a way that they provide and secure practices considered normal in these operations as part of a prudent portfolio management and limit strongly misguided or undue uses to engage several times the same assets or the same security.

That being said, some members would like to insist on the fact that principles laid down by the FSB should take into account the issue of refinancing of banks.

Indeed, we note that certain types of collateral such as CP, CDs and short term corporate bonds, which are currently widely used, could arguably fail the high level principle 1.3. We believe that these types of investment (which are commonly used for short term money market exposures) should be permitted and therefore some amendment of the proposal is desirable.

Regarding the latter segment one might consider to include corporates, hedge funds and sovereigns. European UCITS funds have already regulation on securities.
Same question as for re-use/re-hypothecation: scope of application? (See Q19).
A fund should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.

3.3 Requirement on re-hypothecation (pages 22 - 23)

***Recommendation 9**: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:*
• Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;
• In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and
• Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

⇨ The FBF expresses concerns regarding the potential confusion of "*re-use*" and *"re-hypothecation*" as synonyms where in fact there is an important difference regarding the transfer of titles (which is the case for repos, but not for re-hypothecation)

We would like to stress that re-hypothecation, as defined in the FSB consultation, is specific to some jurisdictions, mainly the US. In other cases, client assets either remain with the client, or are subject to title transfer.

According to that definition, <u>we globally agree with FSB recommendations on disclosure for these types of operations</u>.

But <u>regarding the second principle</u>:

- We are of the opinion that this point should be clarified: does it mean in general that client assets may only be re-hypothecated for the purpose of financing client long positions and covering short positions?

- We believe that the FSB recommendation should not result in a systematic ban of what financial intermediaries can do with the assets they receive as collateral. In this respect, we consider that the distinction made by the FSB between re-use and re-hypothecation of assets should be further explicit on the legal regime applied in terms of ownership of assets posted as collateral in each case. This legal aspect is essential as it addresses the asset protection issue relative to these types of transactions.

- This need for clarification is all the more important that re-use and re-hypothecation concepts are used in different contexts and differently from one jurisdiction to another. <u>The concept of re-hypothecation is primarily a US concept and is not easily exported into the legal regimes in non-US jurisdictions</u> (we remind you that re-hypothecation is not a legal concept in the EU). While in US jurisdictions actual difference with re-hypothecation of client assets are limited, title transfer simplifies and secures the relationship between the parties. Any limitations or restrictions on re-hypothecation of client assets should exclude assets received under a title transfer arrangement (these are not considered as “client assets” in the EU).

<u>In these conditions, we believe that it is preferable to ensure that when financial intermediaries may dispose of the collateral received from their clients, there has been previously a title transfer of the client's assets where assets are given to the collateral taker</u>.

Point to be further clarified: scope of application of recommendations defined as "*non-bank entities".* It does not include banks (i.e. sell side clients) but is much wider than European UCITS funds only (as for ESMA guidelines) with notably inclusion of insurers and pension funds.

***Recommendation 10**: An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation*.

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

- ⇨ The FBF agree with recommendation 9 in relation to disclosures and adequate regulation. We don't see any ground to treat differently re-hypothecation of client assets and re-use of assets received through title transfer (as explained above).

- **3.4 Minimum regulatory standards for collateral valuation and management** (pages 23 - 24)

***Recommendation 11**: Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.*

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?

- ⇨ As regard Recommendation 11, Authorities should focus on methodology and market behaviour but stay absent from quantitative interference in a major market practice.

  Added to that, the FBF want to stress that it is not possible to provide a daily valuation of all assets in collateral or loan. Indeed, <u>some securities are not liquid enough to have a daily valuation.</u>

4 - Policy recommendations related to structural aspects of the securities financing markets
(pages 24 - 26)

- **4.1 Central clearing** (pages 24 - 25)

***Recommendation 12**: Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.*

- ⇨ The FBF do not support mandatory clearing and further analysis should be conducted to assess the costs of benefits resulting from the introduction of a CCP. Pro's and con's are balanced and must be carefully assessed.

- For equity repo where the equity collateral is changed continuously, interposing a CCP will create unwelcome operational hurdles and risks.

- The systemic component of CCPs is more and more highlighted by many participants (including regulators...). Firstly, not every CCP should have same waterfall procedures and capital structures. Secondly linkage between CCPs should be curtailed as otherwise CCPs will substitute the financially intermediary interconnectivity, which was at the roots of the 2008 financial crisis.

- As for further use of CCPs (potential mandatory clearing) the market already has a large dependency on too few CCPs to transact business. For example, Clearnet's relationship with Cassa has caused many worrying themes of late:

  1. Vastly increased haircuts due to the correlation risk they have on their own books, hence we pay for Clearnet's correlation risk!

  2. Overall counterparty limits reduced significantly;

  3. Maturity framework far more stringent.

  In addition, we would like to stress that the vast majority of the trades having less than one week maturity, and very often one day, the contribution of central clearing to the mitigation of counterparty risk is questionable.

  Have the current CCPs got the ambition to take on such a task?
  What happens if LCH is bought by the LSE, will there be a commercial angle?
  Clearnet's current haircut policy, mostly driven by regulation of CCPs, is already causing a deterioration of liquidity.

  Accordingly, the FBF support the development of clearing-houses on these markets but, as long as they are not made a compulsory passage.

- **4.2 Changes to bankruptcy law treatment of repo and securities lending transactions** (pages 25 - 26)

> ***Recommendation 13****: Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties.*

> ***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?***

- ⇨ Regulation within the repo/securities lending world already exists. The GMRA (Global Master Repurchase Agreement) goes through regular reviews, most recently last year, and it has held up well to severe tests such as the collapse of Lehman. It would be dangerous to consider changing bankruptcy law which is the foundations of stability that underpins and reassures the repo market in its current form.

Members find it difficult to understand the reason which would lead to limiting the close-out netting mechanism in the specific framework of the repo activity.

Several regulations/guidelines on resolution regime of financial institutions have already addressed the point globally:

- The FSB guidelines *"Key attributes of effective Resolution Regimes for financial institutions"* include a part on set-off, netting, collateralisation and segregation of clients assets which notably provides for the power for the resolution authority to stay temporarily early termination right, but with no right to make a selection of "good" transactions versus "bad" ones within the same netting agreement (no right of cherry picking);

- Similar provisions are also included in the Dodd-Frank act in USA (Title II – Orderly Liquidation Authority) or in Europe in the Proposal for a directive establishing a framework for the recovery and resolution of financial institution (article 69).

That being said, these measures would have a prudential impact: regarding counterparties, the texts currently in force in Europe (and other areas) take into account the risks on a net basis for the calculation of capital needs according to the regulation within the repo/securities lending agreements in place.