

Secretariat of the Financial Stability Board (FSB)

c/o The Bank for International Settlements

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Financial Stability Board

Initial integrated set of recommendations to strengthen oversight and regulation of shadow banking

Dear Sirs,

The Investment Management Association (IMA) welcomes the opportunity to comment on the FSB's recommendations to strengthen the supervision of shadow banking.

The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of over €5 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds (UCITS and non-UCITS), institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

Key messages

1. We support the efforts of the authorities, at all levels, to regulate non-bank lending and ensure that it does not become a threat to financial stability, and, under the auspices of the FSB, to align their approaches.
2. Differences in domestic law (including accounting and tax) and supervisory approaches (including recovery and resolution), structural reforms and competing political pressures complicate such efforts. Therefore, the authorities should work together to ease such complications.

3. We welcome policies to reduce the susceptibility of money market funds (MMFs) to runs, align the incentives associated with securitisation and dampen pro-cyclicality, and the recognition that supervision should be proportionate and not inhibit sustainable non-bank finance, especially if it is direct investment, often long-term, that does not involve maturity transformation and leverage.
4. The possibility of pushing risk from parts of the financial system where they may be more visible to parts of the system where they may be less visible when making new rules, for example when the Basel Committee finalises its fundamental review of the trading book and reviews operational risk in 2013, should be considered by policymakers.
5. Work Stream (WS) 3 “decided to approach the shadow banking issues through an economic function-based (i.e. activities-based) perspective, rather than solely through an entities-based perspective”. Why don’t the authorities make regulations based on economic substance rather than legal form anyway, subject to safeguards? If that was to be the norm, there would not be any dispute as to whether firms are in the scope of the rules. Entities that do not engage in maturity transformation and are not part of a credit intermediation chain, for example investment funds (including insured and pension funds), can thus be excluded from what measures taken by the authorities.
6. Regulators often target one sector as a means of tackling risks that arise in another, for example the UK Financial Services Authority’s uncertainty about bank originated portfolios of illiquid securities leading to guidelines a year ago that apply to firms rich in liquid assets and minded to swap them for the less liquid ones from banks, or imposing additional capital requirements on banks that transact with alternative investment funds. A direct approach can be more appropriate.
7. Much depends on data collection, regulatory reporting and disclosures to investors. Other regulatory initiatives require their own set of data and reports. It would be helpful to coordinate these requirements as resources to prepare are limited and some measures may be similar, if not the same.
8. The UK and USA have rules, but these are somewhat and understandably focused on their jurisdictions. A global approach to what is a transnational activity would be helpful.

Conclusion

It is clear that the interconnectedness of shadow banks with the regular banking sector will be curtailed, the ability for banks to arbitrage their capital through shadow banking structures will be more limited and shadow banking entities will be subject to at least some bank-like regulation.

By limiting banks' interaction with shadow banks and by closing off some existing shadow bank activity through regulation, further funding gaps will be created. This is in addition to the existing funding gaps resulting from recent changes in bank capital requirements and the general theme of de-risking in the banking sector. This presents opportunities to providers of alternative sources of finance, including investment funds.

We believe that FSB's proposed policy of looking at economic function over legal forms is the correct approach – entities should be regulated according to what they do, and not by what they are called. We also believe that the FSB, by setting international standards for the regulation of shadow banking, has the important task of ensuring that its policy recommendations strike a balance between preventing the build-up of systemic risk in the financial system and stifling activities that diversify risks and provide a much needed stimulus for growth in today's environment.

We look forward to engaging with the Board on its reforms of securities lending and coming up with solutions that are targeted, but still facilitate non-bank finance, especially as Basel III and other reforms change the economics of finance by making bank finance more expensive.

Annexes 1, regarding non-banks, and 2, concerning securities lending, to our letter contain our formal response to the proposals, and further specific observations and questions arising from the proposals.

We hope that you will find our comments useful. Please contact us by way of e-mail (ihenry@investmentuk.org) or telephone on (00 44) (0) 20 7831 0898 should you require further information.

Yours faithfully,



Irving Henry

Prudential Specialist

Investment Management Association

Annex 1

Shadow banking risks posed by non-bank financial entities other than money market funds

Q1. Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?

We believe that the tests to identify the sources of risk to financial stability and principles to apply to mitigate such risks address non-bank sectors.

There will always be the risk of arbitrage. Information-sharing and a flexible, but eternally vigilant, approach go some way to minimise the risk.

Q2. Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).

The functions detailed in Section 2 beg the question why the authorities do not automatically, subject to oversight, regulate on the basis of economic substance rather than legal form.

Q3. Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

The list is comprehensive and guidance to national supervisors. It should be applied in a proportionate manner.

There are many competing demands for data. It would be helpful to coordinate these requirements.

Q4. Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

The tool kit is comprehensive and provides guidance to policymakers. It should be noted that the different interpretations of prudential frameworks, for example the Basel accords, retention element in securitisation and where proprietary trading can take place, enable arbitrage.

Q5. Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers to the extent possible.

It would be helpful to align frameworks, including requests for data, so that compliance costs can be minimised.

Annex 2

Shadow banking risks in securities lending and repos

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.

We have no further comment.

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 have no further comment.

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?

Differences in regulations or the local interpretation of international standards, accounting and structural reforms should be examined in case that they hinder the effectiveness of measures to promote stability.

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.

Measures to promote stability will inevitably change the economics of finance, making lending and borrowing, and transactions with banks and their shadows more expensive. The costs are likely to be passed to the end users.

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)?

Implementation will depend on the urgency of the situation and how difficult, or otherwise, the authorities can tackle the emerging risks.

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.

Members support measures to promote stability, but may not be in a position to provide all the data. The authorities will have to be flexible as to how and when they get the information.

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

We have no further comment.

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

We have no further comment.

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.

It would be helpful to align reporting as much as practicable, so that operational costs can be minimised and the authorities can compare what's going on.

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.

It would be helpful to align disclosures as much as practicable, so that compliance costs can be minimised and investors can see what's happening.

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?

We have no further comment.

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?

Haircuts can work as a refinancing tool, but they can have a pro-cyclical impact. The impact on the ultimate beneficiaries of contracts should be considered. Haircuts also depend on the cost of funding. Some sovereigns may not want to impose haircuts on issuance in their currencies.

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?

The authorities may want to keep all options available. There should be consideration of the impact on end users in the transactions, e.g. investment funds.

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

We have no further comment.

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 have no further comment.

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 pro-cyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

The authorities may want to keep all options available. There should be consideration of the impact on end users in the transactions, e.g. investment funds.

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.

We have no further comment.

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?

We have no further comment.

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?

We support these standards.

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

We support these principles.

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 support these minimum standards.

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?

We support the recommendations.