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Emailed to: fsb@bis.org

The International Securities Lending Association (ISLA) response to FSB's Consultative Document: A Policy Framework for addressing Shadow Banking Risks in Securities Lending and Repos published 18th November 2012

Dear Sir,

On behalf of our members, ISLA would like to thank you for the opportunity to contribute to your consideration of reforms to the securities lending and repo markets. We hope to continue further dialogue with the regulatory community and policy makers and would welcome the opportunity to discuss in depth the views contained in this paper at your convenience.

ISLA is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. ISLA represents members primarily across Europe. For more information please visit the ISLA website www.isla.co.uk

Executive summary

We acknowledge and welcome the efforts of the FSB to assess the potential benefits and risks of unregulated segments of the financial system and we particularly welcome the FSB's efforts to promote international consistency.

Regarding the securities lending and repo markets, we would like to emphasize that a large percentage of this activity is undertaken by regulated institutions. As such existing regulation may deal with some of the risk concerns highlighted by the FSB in its shadow banking review. We support a harmonised global approach to the high level regulation of the securities lending market and for the provision of related data, as there may be inconsistency and uncertainty if different requirements are established at a local level. Given that the securities lending market 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. One observation was that some investors suffered losses on cash collateral reinvestment programs as the value of

hitherto liquid and creditworthy money market investments decreased as a consequence of the crisis. Notwithstanding this, we believe that the securities lending market generally performed well and in the event of counterparty defaults or failures, investors lending securities under master agreements (such as the ones published by ISLA) were able to close out positions, with collateral values more than sufficient to allow for full reinstatement of the loaned securities.

Given this, we would suggest that a sensible approach for ensuring that securities lending does not give rise to financial stability risk is to focus initially on developing further transparency and disclosure (including for the reinvestment of cash collateral), and to establish high level global principles governing collateral management more broadly. We are therefore supportive of the FSB's efforts to develop policy in these areas.

ISLA supports improved transparency for regulators, and participants in the securities lending and repo markets. We believe that a significant amount of the possible data requirements discussed in the FSB paper are already being provided either to data service providers, investors or regulators and that leveraging these existing data sets, would be the most cost effective and efficient way for regulators to obtain the information required. Collecting and aggregating such data through Trade Repositories (TRs) may be a solution to improving market transparency but further analysis is required to establish how this may be delivered. In particular it will be important for policymakers and regulators to agree on what data is required to achieve their objectives before attempting to specify a solution.

Turning to the regulation of haircuts, we are concerned about the possible unintended market disruption that proposals in this area may cause and in our answers below have endeavoured to highlight some examples. We do not believe that a sound case has been made that any inherent procyclical risk in the haircut practices of the securities lending and repo markets was a material factor in the crisis. The risks of getting regulation in this area wrong (such as requiring inappropriately calibrated haircuts) are high given the growing requirements for collateral to support a sounder financial system. Thus we believe that more detailed consideration is needed before policies are defined.

We broadly support the high level principles governing re-investment of cash collateral as outlined in section 3.2.3 of the FSB paper. We believe that end investors should be able to determine their own investment guidelines consistent with these principles. Overly prescriptive regulation in this area may serve to concentrate investments in specific parts of the money markets and could well distort the normal operation of these markets.

Whilst noting that the comments concerning re-hypothecation are relatively short, it is helpful that the FSB provide their own definition of re-hypothecation and re-use. As the proposals do not appear to cover the re-use of collateral received by way of title transfer we do not have any further comment to make on this point.

We support regulatory standards for collateral valuation and management and believe that the proposals are appropriate and consistent with existing market practice. We also generally support the FSB position on CCPs (we agree that the use of CCPs should not be mandated) and note with interest the comments made in respect of potential changes to bankruptcy law and the difficult practical issues this would raise.

As a more general point, whilst much securities lending activity is conducted by banks and other firms acting as agent for their (beneficial owner) clients, some banks offer their clients a principal lending program under which the bank is authorised to lend as principal. This activity is more

common in Europe and consideration needs to be given to how any rules covering haircuts or collateral rehypothecation would be applied to this.

We have provided some more detailed answers to the specific questions below. However in some cases we have been unable to provide the level of detail and analysis we would have liked due to time restrictions. We would, however, like to take this opportunity to offer our assistance in any further research or analysis that is deemed necessary and in particular in the areas we have specifically indicated.

Yours sincerely,

Kevin McNulty,

Chief Executive

Answers to specific Questions

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

ISLA members believe that this and the earlier interim report adequately identify potential financial stability risks that may be associated with the securities lending and repo markets.

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?

As a general approach we believe that there is merit in pursuing transparency measures before attempting to implement other policy recommendations. Some of the recommendations – particularly those relating to minimum haircuts – may disrupt the secured financing markets and care is needed before creating rules. For example should the proposals materially increase the costs of transacting and this in turn reduces the returns received by beneficial owners for lending securities, they may be inclined to withdraw from the market. This would not only reduce revenues to beneficial owners but could also deprive the market of liquidity and may cause increased costs and inefficiencies for all market users. By pursuing greater transparency first, regulators and policymakers have the benefit of observing market behaviours and trends and therefore be better placed to make informed decisions as to whether further (potentially disruptive and costly) measures would be necessary .

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

We believe it is appropriate that FSB policy be focused on financial stability risk matters and given the global nature of the securities lending market it is highly desirable from a market participants and regulators' perspective for these policies to be globally consistent. For example when considering transparency measures, providing a globally consistent framework and leveraging global platforms already in existence would reduce the potential costs and the complexity of how and where to report transactions. This would also enable a more accurate view of the global market (with less risk of missing important exposures or double counting them).

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 mentioned above we believe that measures should focus initially on enhancing transparency and that once this is achieved policymakers should consider further measures in light of real observations.

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.

ISLA believes that most market participants are already providing much of these requirements to either data service providers, such as DataLend, Markit or SunGard, or to their clients. Also, many regulated entities will be providing data to regulators on a regular basis. We believe that leveraging (and where necessary building upon) these existing data sets as far as possible, would be the most cost effective and efficient way for regulators to access the information required and facilitate robust global oversight of securities lending activity

In order to fully ascertain the feasibility of this, we believe a full gap analysis should be undertaken to review the existing data supply and the proposed requirements.

There are a number of specific issues with the proposed data requirements that will require clarification and consideration including:

- Providing clear definitions of each specific data item to ensure a universal understanding.
- Securities loans are not generally individually collateralised, rather lenders receive collateral designed to cover all loans to a specific counterparty. Any reporting framework that requires the allocation of specific collateral to specific loans will require some form of arbitrary allocation which may not reflect the legal basis on which the collateral is received.
- Standardised asset classes for loan and collateral securities will need to be defined
- Ensuring that transactions are not double counted (as for every loan there is a borrow).

If data is provided at a transactional level, the volume of data received will be significant and may require extensive analysis by regulators to avoid double counting transactions reported by multiple market participants (i.e. the same transaction could be reported more than once, by both lender and borrower). Furthermore attempting to understand exposures between participants will require aggregation of very large numbers of transactions and this in turn could create a risk that systemically important risks may not be apparent or may be miscalculated. Regulators should consider whether their objectives can be met by market participants reporting at an exposure level which would correspond to current practice and would more readily achieve FSB objectives. For example reporting exposures to each counterparty broken down by a standardised asset class definition may be preferable and require less analysis by the regulators while still providing the systemic risk insight that the FSB is seeking.

Given the global nature of the securities lending market it is also important to minimise the number of entities requiring data. Ideally surveys and any TR solutions considered in the future would be established on a global basis with a facility for relevant data to be obtained by national and regional regulators. If reporting is required to more than one location, clarification will be required in respect of determining where activity should be reported. For example will this be by jurisdiction of loan security, lender, borrower or agent.

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?

ISLA recognises that Trade Repositories (TR) may be a solution to improving market transparency but believes that further analysis is required to consider the costs and the benefits of this approach versus other approaches. In the context of securities lending it is important to consider whether capturing large numbers of individual trades[1] is a proportionate or efficient method by which regulators objectives of monitoring for systemic risks can be achieved, or whether these objectives are better met by capturing exposures between entities. However achieved, we strongly support a harmonised global approach to the provision of data supported by a globally consistent legal and regulatory framework, as there may be inconsistency and jurisdictional uncertainty as well as higher costs if data is required at a local level.

If it is determined that there is a sound case for a TR, experience from other markets suggests that it can take a period of years to establish an effective one. As an interim measure we support the development of other reporting measures such as official surveys and again would welcome the opportunity to work with the FSB to achieve this.

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?

Please refer to answers to questions 6 and 7. We also believe that authorities should have regard to lessons learned from the establishment of TRs for other markets.

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.

Whilst we support enhanced disclosure, we have some concerns that if the data is required on a transaction by transaction basis, the volume of data may make it more difficult for regulators to understand where systemically important risks might appear. Rather, we believe that data at a higher level, such as exposures to each counterparty would be more useful. These could be detailed in a way that ensures regulators have sufficient information to meet their objectives, such as by counterparty and asset type for loans and collateral as well as haircuts levels applied.

A number of practical issues that will need careful consideration are detailed in our answer to questions 6 and 7.

[1] Equilend, a company providing trading and post trade services to the global securities lending market reported average daily loan volumes in excess of 20,000 per day in 2012. As not all transactions are processed through Equilend the actual number of transactions will be higher.

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.

ISLA supports disclosure to investors and welcomes any progress in this area. It should be noted that the industry has made significant improvements in this area over the last few years and a number of current or proposed amendments to regulation will further assist in this, such as the work ESMA has undertaken in respect of ETFs and other UCITS.

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 believe that more detailed consideration is needed before it can be decided whether policies should be defined for minimum haircuts and would welcome the opportunity to work with the FSB in undertaking further research and analysis. In terms of priorities, we believe it would be appropriate for authorities to develop rules that will provide them with relevant data from the market, and then, with the benefit of improved transparency to consider whether regulation of haircuts is desirable. Whilst we understand the FSB's intentions in this area we would point out that regulations like Basel III, Dodd Frank and AIFMD already contain measures designed to achieve the goal of restricting leverage and limiting procyclicality.

In terms of risk based methodology, care needs to be taken that the methodology does not conflict or disrupt the lending markets where naturally risk averse beneficial owners require haircuts in order to continue participating in the activity. For example, if a beneficial owner investor (such as a pension fund) is lending equities against AAA sovereign debt, a risk based calculation may suggest that the beneficial owner should provide a haircut rather than receive it, which would not be acceptable to many beneficial owners, who expect to receive haircuts on all activity.

Also for securities lending activity, the use of tri-party collateral managers means that haircuts are usually defined (perhaps with consideration of a risk model) by collateral types and agreed prior to any specific loan transaction being agreed. In defining these, the lender will consider the types of assets made available to borrow but will by necessity look at this on a holistic basis.

The potential for the added complexity and effective prevention of profitable business as lenders lose flexibility in adjusting margins as they see fit under the circumstances, may lead beneficial owners to reduce or stop activity which in turn may have a significant impact on market liquidity.

It should also be noted that all banks subject to Basel III will be subject to capital charges already if haircuts are not applied at an appropriate level, so there is a risk that two sets of conflicting rules are created for these participants.

If risk based haircut calculations are required, there are a number of aspects to the proposals which will need to be further considered and clarified;

- Should the requirement of risk based haircut calculations apply to all activity or only financing trades? (this approach would be consistent with the proposals for numerical floors.)
- Whether it is appropriate to apply the requirements to all market participants or to a sub-set as described in the proposals for numerical floors. Given the existing Basel III requirements,

it may be more appropriate to apply these requirements only to clearly defined financing transactions between non-regulated entities.

- If haircut methodology is introduced the credit-worthiness of the counterparty should be a factor in the calculation and further clarification regarding the correlation requirements will be needed to ensure a consistent approach.

ISLA strongly recommends that further research and analysis is undertaken before anything is implemented in respect to imposing haircut methodology or numerical floors to haircuts as the possibility of disrupting market activity is significant.

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?

We have a number of concerns about the application of numerical haircut floors and for potential unintended consequences.

Firstly they may, over time, lead some participants to rely on the floors as 'market standards' rather than undertaking appropriate analysis themselves, which may lead to participants taking more risk than is reasonable and could subsequently increase procyclical risk in times of market stress.

A lender may not be able to determine whether a transaction is for financing or other purpose so consideration needs to be given to how to determine a financing transaction for the purposes of applying numerical floors to haircuts and how to manage transactions that change in purpose. In the first instance there needs to be a clear definition of what represents a financing transaction.

A further risk is that numerical haircut floors may not reflect current market levels given their insensitivity to risk (a numerical floor is static whereas the current levels are reset dynamically by the market depending on underlying risk factors and conditions). As such, there is a concern that the imposition of numerical haircut floors may have unintended consequences in practice. If haircuts are set higher than current levels, it may have the effect of excluding the impacted asset class as collateral, thereby causing a large impact on the liquidity of the affected asset. This may in turn have a destabilising effect on the market by increasing borrowing costs for issuers of the asset concerned.

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?

If regulation of haircuts proves to be a requirement we believe that the focus should be on the methodology that lenders use for calculation of these, rather than the application of fixed numerical floors.

Notwithstanding the difficulty that a lender faces identifying financing trades, we support excluding non-financing driven securities lending and borrowing from any requirements.

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

Global harmonisation of any imposed numerical haircut (or risk- based methodology) will help in avoiding regulatory arbitrage. Careful consideration needs to be given to if and how this can be achieved as well as the interaction/ impact any proposals may have on capital regimes such as Basel III and Solvency II which already have defined risk based methodology.

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?

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?

ISLA believes that the application of any new rules for haircut management should be limited to financing driven transactions where the party obtaining finance is not subject to existing regulatory requirements for haircut or liquidity management (such as those proposed under Basel III or Solvency II in Europe).

Whilst this narrows the scope of application, we believe that alongside existing capital regimes this will ensure that regulator's objectives are met. Notwithstanding discussions about the definition of what is shadow banking, the objective of reviewing the sector is to ensure that financial activities are adequately regulated. To the extent that an activity is already subject to prudential regulation we do not believe that further (and possibly conflicting) regulation is required or is constructive.

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?

As detailed in our answer to question 11, margins for securities lending are almost universally set at portfolio level rather than applied to individual transactions. Lenders generally set haircut requirements by collateral and loan asset types, creating a matrix of required haircut levels. This approach is better suited to risk based modelling methods for determining appropriate haircuts as the models can take into account correlations of portfolio returns. Reviews of risk based models should be undertaken regularly to ensure that these are providing an acceptable level of protection.

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 broadly support the high level principles governing re-investment of cash collateral as outlined in section 3.2.3. However we note that certain types of investments 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 to allow cash collateral to be re-invested in such routine money market instruments.

We support further improvements in transparency to underlying clients by the entity undertaking cash collateral re-investment and would welcome the opportunity to work with the FSB in establishing market standards for this. We believe that individual investors should be able to determine their own investment guidelines consistent with the principles and the investor's own stated risk appetite. By improving transparency the investor should be able to achieve this without the need for further prescriptive standards.

Any regulation aimed at cash collateral re-investment should be directed toward the end investor and not the agent lender as the latter often acts on behalf of a number of different clients subject to different regulatory requirements.

Whilst we recognise the policy objectives of setting restrictions for maximum weighted average maturity (WAM) or weighted average life (WAL) it should be noted that these do not take into account the term structure of the underlying (securities loan) transactions and may reduce the investors' ability to appropriately match their liabilities. This highlights the difficulty in defining absolute restrictions which are appropriate to all market participants.

If a policy has to include absolute restrictions we believe these should be set at the outer limits of acceptable ranges to a) act as a backstop control on the amount of system wide maturity mismatch and b) not to create distortions in the money markets (as securities lenders globally are forced to invest in the same narrowly defined maturities). In order to ascertain what the appropriate levels might be, further analysis and market consultation will be required.

Where re-investment is made via regulated money market funds, we believe these should be excluded from stress test requirements and any additional requirements, given that these should automatically meet the high level principles by definition.

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

We note that the comments in the paper concerning re-hypothecation are relatively short. Whilst there is some reference to the possibility of imposing strict limits through globally harmonised rules, the paper seems to favour increased disclosure instead.

The distinction made in the paper between rehypothecation (involving client's assets) and reuse (which covers the securities received by way of outright transfer, such as collateral received in a securities lending agreement) is helpful. As the proposals do not appear to cover the re-use of collateral received by way of title transfer (which is a common form of collateral transfer in the securities lending market) we have no further comment to make. We do not believe that an institution that receives collateral by way of outright transfer should be restricted from re-using it.

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 regulatory standards for collateral valuation and management and believe that the proposals are appropriate.

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 recognise the potential benefits that Central Counterparties ("CCPs") bring to some securities and derivative markets but support the FSB position that this approach may not be appropriate in the securities lending market. Requiring that securities lending be centrally cleared could result in investors withdrawing from lending their securities (as consideration would need to be given to the new risk characteristics and economics of a CCP model) and this would be disruptive to markets. We agree that the existing benefits of using a CCP (such as the potential balance sheet netting and lower capital requirements) could create the necessary incentives for their use.

To the extent that CCPs could address some of the highlighted concerns with respect to transparency, we believe there are a number of alternative and more comprehensive approaches to increasing transparency. We believe enhanced reporting (or a trade repository), supported by a globally consistent legal and regulatory framework, may play a role in addressing issues of transparency, subject to the establishment of globally consistent parameters for reportable data to ensure meaningful analysis of the market without placing undue burden on market participants.