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Secretariat of the Financial Stability
Board
C/O Bank for International Settlements
CH-4002 Basel
Switzerland

By email: fsb@bis.org

Zürich, 14 January 2013

Re: FSB Consultations on Shadow Banking

Dear Sir/Madam,

UBS would like to thank the Financial Stability Board for the opportunity to respond to the Consultations on Shadow Banking.

We would be happy to discuss with you in further detail any comments you may have.
Please do not hesitate to contact Frank Wulms on +41 44 234 22 39 or at frank.wulms@ubs.com if you have any questions.

Yours sincerely

UBS AG

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1. Introduction

UBS would like to thank the Financial Stability Board (FSB) for the opportunity to comment on the three Consultation documents *"Strengthening Oversight and Regulation of Shadow Banking: An integrated overview of Policy Recommendations"*, *"A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking entities"* and *"A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos"*. Please find below our overarching remarks, as well as comments on the specific work streams and the questions set out in the documents.

We acknowledge and welcome the efforts of the FSB to assess the benefits and potential risks of shadow banking activities outside the regulated banking environment and we particularly welcome the efforts to promote international consistency. Overall, we agree with the need for policy to ensure that risks of shadow banking activities are not transferred to other parts of the financial system and agree that circumvention of the current rules and regulatory arbitrage is a concern. At the same time, the benefits of non-bank financial activities as an important source of additional funding should be preserved.

Furthermore, we would like to point out that many parts of the banking industry, including large parts of the shadow banking area, performed well prior to and throughout the crisis. Recent studies have shown that the repo (bond) market has actually been a stabilizing factor during the financial crisis 2008-2009.

Securities lending and repos as well have a positive impact on financial stability as they contribute to the liquidity of the securities markets (efficient valuation, less volatility, addresses settlement bottlenecks, etc.).

We would therefore argue that the focus of this regulatory framework should be set on specific non-bank financial activities with the potential to create systemic risk. An attempt to produce an all-encompassing policy and regulation covering shadow banking would bear significant risks, including hampering liquidity in key markets, increasing the costs of doing business for firms within and outside the financial sector, heightening the risks of fall-out and thereby potentially weakening financial stability rather than increasing it.

We ask the FSB to consider whether the risks identified are addressed by measures already implemented or in the process of being implemented (in particular Basel III, and Dodd Frank) within the currently regulated banking environment and, if not, how the particular risks can be most effectively addressed by considering the least invasive/distortive measures.

We are concerned about proposals for indirect regulation (regulating the links between the banking system and shadow banking entities via banking regulation) and believe it to be an ineffective way of addressing potential systemic risks. We would emphasize the fact that the primary driver of shadow banking is the increasing level of regulation of the banking sector itself and its resulting cost burden.

UBS's detailed responses to the specific questions and recommendations posed in the Consultation documents follow below.

2. Consultative Document: "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking entities"

Overall, we agree that regulation is important, yet not necessarily the only tool. The principle of the activity-based approach is welcomed, and we would appreciate further dialogue with the industry to discuss related difficulties in categorizing activities into a single economic function. This is particularly important, as we perceive the proposed toolkits to be entity-targeted. As such, the practicalities of an activity-based approach might be difficult to implement. In this respect, we would like to draw the FSB's attention to the possible cumulative effect of existing and planned regulation, in particular in the EU. The review of MiFID extends the scope of regulation to e.g. cover all high-frequency traders and more commodity investment firms. It also increases transparency of non-equity instruments. The Alternative Investment Fund Managers Directive (AIFMD) introduces new requirements for alternative investment funds in relation to disclosure and management of liquidity and leverage.

Consultation questions:

1. *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 agree that improvements could be made through appropriate increased levels of transparency. This should be dealt with in the fund regulation. In this respect it is our view that the ETF industry is providing an example of best practice to the rest of the funds industry and we would like to refer to the work undertaken by ESMA here. However, we do not support the view that investment funds, including Exchange Traded Funds (ETFs), which provide credit or are leveraged, should be considered shadow banking entities / activities as they are already heavily regulated. While we agree that the underlying assets, held either directly or indirectly as collateral should deliver capital preservation and liquidity to investors in the event of a counterparty default, we do not agree that there is a conflict of interest where securities lending/swap transactions take place between counterparties of the same group. Potential conflicts of interest have already been addressed under existing regulation, including UCITS IV.

2. *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).*

It is our view that ETFs are also funds, the only distinction being that they are traded on exchange. It is therefore not entirely clear to us why ETFs are specifically identified within this section i.e "short-duration exchange–traded funds", when short-term bond funds are already identified. Additionally, ETFs represent a very small part of the funds universe (< 4%). With respect to the impact a run on an entity engaged in maturity or liquidity transformation could have on financial stability, it is not clear why ETFs should be considered such a risk. Indeed, the role performed by an ETF market maker reduces this very risk through the use of exchange spreads and by absorbing fund shares as inventory on its own book to manage liquidity.

It is correct that certain providers of synthetic ETFs did deposit low quality equities on to the balance sheets of their funds. However, this practice has been tackled in Europe under the ESMA Guidelines (July 2012), and is irrelevant in the US, where synthetic ETFs are not allowed. The fundamental issue is where the ETF providers' interests are put before the investors, and this is most clearly evident where there is not a clear distinction between the swap counterparty and the portfolio manager. Such stocks being held on a funds balance sheet are only relevant to investors in the event of a default by the swap counterparty, at which point investors' interests are clearly centred on capital preservation and liquidity. Whilst not actually collateral, in the event of counterparty default their purpose is the same.

From a UBS perspective, it is therefore more relevant in terms of financial stability to focus on the quality of collateral posted and related to OTC derivatives contracts in general. For instance, equities are a common instrument used for posting as collateral, and so appropriate haircuts according to the quality of the collateral should be established and standardised to prevent regulatory arbitrage.

3. *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.*

ETFs are typically retail funds and are therefore subject to stringent regulations, which in Europe, within the UCITS framework, already address the issues associated with runs on liquidity. ETFs benefit from the additional control provided for by the market makers' application of on-exchange spreads and the maintenance of their own inventory to manage demand.

3. Consultative Document: "A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos"

We welcome the FSB's approach to consider the risks from specific activities and search for ways to best mitigate them.
At the same time, we would like to emphasize that a very large part of the activity in securities lending and repos takes place between regulated banks. Risks stemming from any such activity should be addressed solely in banking regulation, and not additionally in separate shadow banking rules. There are already several regulations in place and additional new regulation with a specific focus on securities lending and repos is coming up. This in addition to the frameworks mentioned earlier (including the ESMA Guidelines on ETFs and UCITS, as well as several national regulations, including the CISA framework, the CISO-FINMA guidelines for pension funds and insurances, the FINMA-Circular 10/2 in Switzerland, or the CSSF requirements in Luxembourg). We ask the FSB to consider these regulations before issuing additional recommendations for these activities.

Overall, we agree that the specific issues highlighted, like collateral management, cash reinvestment, re-hypothecation, transparency and market infrastructure, are the right areas to focus on with regard to the general concerns of shadow banking affecting financial market stability. As such we can support most of the recommendations. It could be useful to provide clear definitions of the (technical) terms utilized throughout the consultation documents to avoid misunderstandings.

Part of this consultation paper is about the use of limits. We would like to note that it is already best practice to set self-imposed limits in several areas of securities lending and repos, e.g. limits for equity borrowing and lending based on the liquidity and the quality of the asset in question and collateral posted/pledged. We would welcome the FSB adopting these practices. While we support limits on assets in which collateral may be invested and on the dealers' ability to re-hypothecate collateral, we would caution against imposing minimum margin or haircut requirements.

From a country-specific point of view, we would furthermore like to point out that different markets offer different kinds of securities lending, involving different market participants. An example here is the so-called pool principal model, which is a market practice in Switzerland. In this model, the bank borrows assets from a pool of clients (potentially 1'000s that are generally in custody with the bank) and distributes these assets as a principal into the interbank market.

As for the specific recommendations (and their related questions) in this Consultation paper, we have grouped our response into five major topics:

3.1 Transparency (covering recommendations 1-5)

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.

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.

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.

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.

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

We acknowledge and support the drive for enhanced transparency in Shadow banking and in particular in Securities Lending and Repo markets, to the extent that these activities are developed outside the regulated banking environment. Prior to any decision being made around a Trade Repository (TR) being the appropriate solution, local regulators should be surveyed for a solution that meets their own needs in reaching the objective of the policy goals.

A more detailed survey of already available reporting and its suitability for meeting the policy goals would be welcomed for several reasons:

- From the banking side, there are existing periodic reports, containing aggregated trade data that are submitted to the various regulators globally that, expanded with more detail, may fit the purpose. Therefore, consultations with regulators to ensure the data is appropriate are a sensible approach, as described in the policy document. Subsequently to the survey, serious consideration need then be made around the level of detail required and the publication of information in the TR.

There is a risk that large amounts of trade data may make the regulators' job difficult to meet the policy goals. A local regulator will not be able to have an overview of globalized trading activities based on the information available at its local TR. There may be inconsistency and jurisdictional uncertainty if data is required at local level, thereby potentially confusing the regulators' view and increasing costs. 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?

- The other, more material risk to the securities lending market will involve misuse of the data within the TR by market participants as trading data, reducing the liquidity of the market. This will be exhibited through lenders and borrowers seeking to arbitrate new transactions against data published from the TR.
- The European Repo Council has also contemplated this topic and external service providers have pitched for responsibility in this space. We also believe, as an interim solution, that existing reporting into ICMA (European Repo Market) and the FED (US) could be enhanced to provide a near term response to demands for extra transparency.
- Further examples of existing reporting requirements include the general public disclosure made by banks, as in place in many jurisdictions, and the reporting requirements Fund Managers have towards their end investors. In this respect, the upcoming ESMA regulations might be useful to consider.
- As for the specific data, we also believe that a survey would help to provide better insight in the type of data required and already available. Using transaction-level data may lead to data flows too large to handle in a practical and relevant way. In this respect, aggregate exposure-level data may be more effective.

Overall, we believe that active involvement of the industry will contribute to achieving the policy goals of increased transparency. With input from the industry the regulators can determine what data would best support the monitoring of systemic risk and could also determine the best approach for collecting and analyzing such data.

Finally, we see a number of challenges which should be made explicit: It is important to provide clear definitions to ensure a good understanding. Proper transparency requires agreement between regulators on the nature and attributes and we note certain concerns about the re-use and control of the data with an external service provider. We would urge regulatory ownership of such a utility in order to mitigate this risk.

3.2 Haircut Methodologies and Minimum Haircuts (recommendations 6/7/11)

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.

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).

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

General comments and minimum haircuts

We fully understand the FSB's intention and we overall support a framework for haircuts. At the same time we wish to draw the FSB's attention to the fact that Basel III, Dodd Frank, or certain national regulations we referred to on page 4, already contain effective measures to achieve the goal of restricting leverage and limiting procyclicality.

We believe that the determination of haircuts should be made, without reference to minimums, on a principle-based approach. Haircuts should be a function of the underlying liquidity of an asset, the quality of the credit and an individual organization's ability to liquidate a position. The establishment of minimum haircuts may have the unintended consequence of increasing financing costs, which would be passed on to the issuer and would hence impact liquidity. In this respect, we would consider it beneficial to conduct further studies to assess the impact of such minimum haircuts. They may also increase costs of secured funding, as liquidity is reduced from the market by high haircuts. Furthermore, outsized haircuts would directly impact risk weighted assets, potentially making secured funding significantly more capital intensive and uneconomical. This would undermine the objectives of Basel III.
Additionally, we see a potential for conflict between a localized haircut-based limitation on leverage and the broader Basel III framework, which introduces a Leverage Ratio and additional Capital constraints. Repo activity is sensitive to both measures.

We would like to raise the attention to the fact that mandating minimum margin or haircut requirements could lead to even greater risk being introduced into the system, as banks are no longer able to adjust haircuts to mirror the counterparty risk exposure.
With respects to transaction types, it can be difficult to differentiate between a borrow/lend-driven securities lending transaction, or a financing/collateral swap transaction. This may lead to arbitrage and may, in effect, circumvent any haircut floors imposed.

The consultation document makes no mention of required margin on securities lending transactions that are currently applied to the principle borrow/loan. This may be in addition to any haircuts applied to collateral and therefore inclusion of this should be considered within any review of haircut floors. Additionally, we would like to note that for financing and securities lending activities, collateral is to be marked to market (or should be made mandatory), with daily margin calls issued.

Minimum standards for methodologies

Many firms already analyze methodologies in the way described in the consultation paper, and this seems an acceptable approach.

Numerical floors on haircuts

As mentioned above, we estimate that minimum haircuts may not be the most effective way to address over-leverage and limiting procyclicality.
We re-iterate our concerns of the practicality of introducing a minimum haircut, as it would not be sensitive to the creditworthiness of the counterparty, meaning that each participant would potentially be treated in the same manner as the least creditworthy counterparty. Hence, there is a danger of imposing inappropriately high haircuts on sound counterparties, thereby removing mechanisms from the market that give advantages to good rated counterparties.

The paper says: "Any numerical floor should apply only to securities financing transactions where the primary motive is financing, rather than to lend/borrow specific securities, consistent with the key principle of limiting the build-up of excessive leverage in the financial system." It is an objective from regulators to have secured / collateralized funding. In this context it would be beneficial to have a clear definition of a financing transaction in the context of this paper.

Minimum regulatory standards for collateral valuation and management

The standards mentioned are largely followed by market participants. We would also like to refer to the existing industry standards (e.g. ICMA), which serve as best practice. It is important that valuation standards reflect market practice. We would like to emphasize that for Repos the standard industry contracts already contain the legal right for daily valuation and securities lending already does daily mark-to-market.

The consultation document does not mention the required margin on securities lending transactions that is currently applied to the principle borrow/loan. This may be in addition to any haircuts applied to collateral and therefore inclusion of this should be considered within any review of haircut floors.

3.3 Re-hypothecation (recommendations 9-10)

Recommendation 9: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:

i. 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;

ii. 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

iii. Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

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.

We understand the desire to ensure adequate regulations for governing re-hypothecation of client assets. The FSB definition of re-use is in line with our view, however, the definition of re-hypothecation should be narrowed further to exclude those client assets which are explicitly used for securities lending transactions, such that the intermediary is acting as either agent or principle to further lend on the client assets for a fee, part or all of which may be payable to the client.

Furthermore, in terms of clear definitions, we would like to point out the existing practice of "principle-pool securities lending" in the Swiss market, whereby a pool of assets (eg of institutional or corporate clients) is agreed to be made available for securities lending and the assets are distributed in the interbank market in a principal to principal transaction. In the latter context, there are legal agreements defining the mutual rights and obligations of the beneficial owner (eg an institutional client) and its bank.

With respects to the point restricting intermediaries from re-hypothecating client assets for the purpose of financing own-account activities, the own-account activities must be clearly defined. When applied to the Prime Brokerage model, standards should be established on the value of assets that are re-hypothecated, such that the percentage of assets available for re-hypothecation is based on client indebtedness and that they are specified in legal agreements and adhered to.

The FSA, for example, issued a requirement for re-stating firms' definitions. It is also important to note that while the intermediary agrees to finance a client on the basis of ability to re-hypothecate, this in no way reflects the actual value of assets re-hypothecated (i.e. it may be less), or for which transactions those particular assets finance (e.g. intermediary uses to cover own or other client securities lending activity).

Restricting this type of activity will make it costlier to finance assets and would force a further liquidity drain on client assets. Lastly, while disclosure can be made on client assets that have been re-hypothecated for purposes of financing indebtedness, it is not possible to determine how the third party further re-use those assets.

3.4 Collateral Reinvestment (recommendation 8)

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.

We broadly support the high-level principles mentioned in the paper. To supplement the FSB proposals, we would like to point out the existing best practice guidelines, like ICMA guidelines, which many market players already apply.

We are supportive of limits on maturity or type of assets in which cash collateral may be invested. We would like to draw attention to the fact that regulations already exist on the side of banks and regulated institutions like investment funds, with detailed requirements as to collateralization. Therefore, we do not see a need to further regulate and introduce specific rules e.g. on collateralization and the type of collateral to be used, neither directly nor indirectly through specific rules on capital adequacy.

Overall, we would favor a principles-based approach. We believe that any prescription in terms of, for example, pricing source would actually lead to a reduced confidence and requirement for higher haircuts in order to minimize closeout risk.

3.5 CCP (recommendation 12)

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.

We recognize and understand the drive towards use of CCP in the Secured Funding markets. Overall, we consider it important that the cost and benefit of such an approach is studied in detail before being implemented.

A number of recent policy papers have recommended that repos should be transacted through CCPs. Also, we would like to refer to existing CCP options available in the US, like the Options Clearing Corporation (OCC). A lack of significant participation on the OCC for securities lending suggests that the market doesn't see much value in such a utility. Similar experiences were made in Europe. As for repos, there are already some CCP solutions in place, such as the FICC, or the Repo Clear at LCH, which have proven to be robust organizations in terms of effective risk management.

In terms of the suggested cost / benefit analysis (potential capital discounts by the regulators, B/S efficiency / optimization, vs cost of implementation for the banks, initial margining, etc.), we would like to share the following thoughts and questions with the FSB:

- There is a need to understand the potential liquidity impact (including margin) in participating in any CCP platform. A CCP could actually make funding less available and increase systemic risk. Also, there is a need to assess the capital/RWAs impact under Basel III.
- It would be important to understand how such a platform would work in the context of different asset classes and tenors. With a term transaction, haircuts/margin would likely have to be fixed and thus might not attenuate risk. Also, a CCP generally lends itself more to plain vanilla products - and this is not an area that has generally created/exacerbated systemic issues.
- How would such a platform operate in the context of the buy-side/real money accounts, for example? Would they require a clearing member in order to transact? What about activity conducted via agents?
- How would such a CCP be structured? As a utility or for-profit enterprise? Would there be multiple platforms?
- We believe there could be a risk of disintermediation involved in CCP, ie removing regulated and experienced players (eg global banks) from the market value chain, thereby giving the possibility of smaller actors to participate directly with all associated consequences (lower aggregated creditworthiness, moral hazard, etc.)
- Overall, CCP(s) need to bring to the market a broad set of functionalities (different markets / countries / currencies, handling all type of corporate events, potentially clearing services, etc.) which are complex / expensive and will therefore carry large costs to the users. This must be considered in the overall cost / benefit analysis.
- And at last, we would like to mention that with an increased CCP comes an increased capital cost, which would drive the market spreads outwards.