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Switzerland

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AFG response to the Financial Stability Board consultation on 'Strengthening Oversight and Regulation of Shadow Banking'

General comments

The Association Française de la Gestion financière (AFG)[1] is grateful for the opportunity to answer to the European Commission's on 'A possible recovery and resolution framework for financial institutions other than banks'.

The Association Française de la Gestion financière (AFG) welcomes the opportunity offered by the FSB's open debates around shadow banking to express the French asset management's opinion on the topic. AFG response follows the FSB consultative document and therefore is divided in three parts: "An Integrated Overview of Policy Recommendations", "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities", "A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos".

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Sincerely Yours,

Signed

Pierre Bollon

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 425 management companies as of end January 2012. They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members manage 2,650 billion euros as of end December 2011, making the Paris Fund Industry the leader in Europe for the financial management of collective investments. In the field of collective investment, our industry includes – beside UCITS – employee savings funds, schemes and products such as regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment. AFG is of course an active member of the European Fund and Investment Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING

An Integrated Overview of Policy Recommendations

General comments

We strongly believe that the Asset Management industry in Europe should not come under the scope of «shadow banking» (SB). As a general rule, the greatest majority of collective investment funds in Europe are strictly regulated by the UCITS Directive or national laws that will gather under the European umbrella with the AIFM Directive that comes into force in 2013. Maturity and liquidity transformation as well as the credit risk exposure and the leverage effect are tightly limited and monitored. In this respect, it should be stressed that risks come from the excessive use of techniques which is neither limited nor monitored and it is not the case for funds packaged as UCITS funds or as funds nationally regulated that will be monitored soon under the AIFM Directive.

1. FSB's approach to shadow banking

AFG believes that shadow banking should be linked to non-regulated entities or structures embedding systemic risk. We believe that the collective investment industry does not correspond to any of these categories.

"Shadow banking" should imply opaque activities bearing systemic risk, with no definition or specific rules attached. We strongly stress that the collective European asset management industry is tightly regulated both at the activity and actor levels with materially reduced non-financial risks. The European fund industry is a highly transparent industry that plays a stabilizing role for the economy, and as such cannot be captured in the "shadow banking" scope. Indeed, Money Market Funds (MMF) and Exchange Traded Funds (ETF) should not be mentioned as shadow banking (SB) entities.

AFG agrees with the two-steps approach presented in this consultation. AFG wants to insist in the importance of the definition of the scope authorities should monitor. In that sense AFG believes that the word *shadow banking* should be rather changed into *shadow finance*. This is because shadow banking could wrongly imply that non-bank regulations are lighter regulations than the banking one. Actually, non-bank regulations are as highly protective as non-bank ones, are subject to on-going regulatory scrutiny and have consistently succeeded to address risks. For instance, the occurrence of accidents could be a very good metric of success of the European non-bank regulation (and especially the asset management regulation we are subject to).

In our view, it is necessary to avoid confusing the concept of "finance" which is generally the provision of monetary resources and "banks" which represent a specific branch equipped to collect deposits and specifically regulated for the purpose of maturity and risk transformation, a characteristic that amply justifies a certain number of "privileges" such as the access to central bank liquidity.

Asset managers are very much concerned that a misconception of their activities could lead to inappropriate consolidation of some of their activities into the perimeter of a parent bank for prudential regulation. Banks usually do not provide any guarantee in favour of clients who invest in the funds they distribute. In case there is a guarantee, such products are highly regulated and controlled. Investment funds managers in any case do not bear any guarantee in their balance sheet and investors are totally aware of the market risk they take. In any case, any regulation of these activities must be preceded and followed by the appropriate measuring means making it possible to identify the activities, to measure positions and flows and to indicate the sensitive spots where to carry scrutiny and potentially regulation.

2. Money market funds

AFG shares the analysis done via the consultation on money market funds and full endorses the recommendations from IOSCO. We strongly think that regulated Variable NAV MMFs are not part of shadow banking activities.

French MMFs are investment products like other funds. Their creation must be authorized by the AMF (French regulator) and are been classified by the AMF as money market funds since 1987. They comply with the UCITS Directive and are subject to the restrictions set forth in the Eligible Assets directive and the July 2011 ESMA Guidelines on a common definition on European Money Market Funds. French MMFs cannot be created with a constant NAV, but only with a floating NAV, as any other funds. This means that French MMF's NAV is subject to the funds underlying's valuation and as such their share price can fluctuate from positive to negative performance.

FSB will find at the end of this part the AFG view on each IOSCO's recommendations on MMFs.

3. Other shadow banking entities

Policy measures presented in the document to get proper information on shadow banking (SB) activities should be supported. The five areas identified as SB activities include the discrepancy between long term investments and short term liquidity. It must be stressed that not all investors redeem at the same time thus allowing for some less liquid investments for a limited portion of the assets. The strict rules applying to funds and especially UCITS to ascertain their liquidity should be carefully analysed by FSB to understand how the industry properly manages that type of risk.

4. Securitisation

The need to restore investors' confidence in securitisation is urgent as the economic efficiency of well-structured securitisation will become more and more important in the new post Basel 3 world. Labelling, risk retention, direct information of investors, insight on the methodology used by rating agencies an transparency on rules to manage conflict of interests… are among the necessary steps.

5. Securities lending and repos

AFG will join to this response a detailed answer to the consultation paper on “A policy framework for addressing shadow banking risks in securities lending and repos”. We would like to point out that most of the financial stability issues described in the document are already within the scope of several European directives and regulations, such as MIFID, MIFIR, EMIR and MAD. Those directives and regulations will soon enter in force in the EU and may answer the FSB concerns. Additional recommendations/regulations may lead to a negative pro-cyclical effect for European participants.

We also underline the importance to address the issue of securities law in order to make it impossible to have more certificates circulating than shares issued. We stress the fact that securities lending and repos transacted by non-leveraged vehicles (like UCITS or AIF with a leverage lower than 3:1) should be exempted from numerical floors on haircuts and should benefit from any exemption that may be introduced, as they are far less risky than any bank lending.

AFG COMMENTS ON THE IOSCO FINAL REPORT ON POLICY RECOMMENDATIONS FOR MONEY MARKET FUNDS

AFG first wants to affirm its total accordance with the IOSCO Final Report on Policy Recommendations for Money Market Funds.

AFG represents variable net asset value (VNAV) money market funds of the French market which represent an important market. AFG did contribute to the consultation done by IOSCO on that topic on April 2012.

Also AFG understands that FSB' mandate to IOSCO indicated that a key issue to be considered was the constant net asset value (CNAV) feature of some money market funds. Even if money market funds did not cause the crisis, some of them alerted regulators to the systemic relevance because of run they may face. AFG agrees then with the FSB objective to propose regulatory reforms that would mitigate their susceptibility to runs and other systemic risks.

AFG particularly appreciates that in its analysis of the situation IOSCO took into consideration also recent developments regarding money market funds in the context of the very low interest rate environment.

AFG's expectation after this consultation and final report on MMFs is that once IOSCO recommendations are put in place by the regulators, MMFs would not be considered as Shadow Banking. AFG is supporting this implementation actively at European level. MMFs are broadly used by retail and institutional investors as an efficient way to achieve diversified cash management and they provide a significant source of credit liquidity and this should remain possible.

AFG stresses that, as said in the report, reforms on MMFs were undertaken, and VNAV proved their resilience during the crisis some MMFs faced after the 2010 reforms. They had no runs due to their exposure on European debt nor did they have important outflows due to the negative returns. Thus we think the reform was well implemented and efficient in order to clarify positions to the clients. We suggest that some effort on transparency regarding the amortized cost valuation should be developed from the framework put in place with CESR Guidelines.

AFG doesn't consider that the remaining sources of concerns for financial stability are relevant for VNAV MMFs. (i.e. stable NAV, first mover advantage, discrepancy between the published NAV and the value of the assets, implicit supports, and importance of rating)

But, as said, some improvement could still be made to avoid any misunderstanding on VNAV and that is why AFG and members are proactive to comment any topic with authorities (like currently with the European Commission) and is working on the publication of an industry Code Of Best Practice for French Asset Managers of MMFs, which is to be adopted in the coming months.

You will find hereafter AFG's position on the recommendations listed in the final report. As a general remark it is important to know that AFG's members are already in line with ESMA (ex CESR) Guidelines and are also positive in the way the European Commission would be able to adapt those rules at a higher level.

Recommendation 1: Money market funds should be explicitly defined in CIS regulation.

AFG thinks, in France, this is correctly implemented with the AMF classification taking into account the Money Market Categories set up by ESMA. (i.e. short term MMF and MMF).

Recommendation 2: Specific limitations should apply to the types of assets in which MMFs may invest and the risks they may take.

AFG thinks ESMA (ex CESR) Guidelines are well defined and clients view on the MMF target is better.

Recommendation 3: Regulators should closely monitor the development and use of other vehicles similar to money market funds (collective investment schemes or other types of securities).

AFG agrees that this should apply to all types of vehicles in order to avoid discrepancies. AFG would like to stress the fact that some dedicated/specific funds may not be able to get fully in line to all the money market guidelines because of their legal structure.

Recommendation 4: Money market funds should comply with the general principle of fair value when valuing the securities held in their portfolios. Amortized cost method should only be used in limited circumstances.

AFG members are currently developing this point in the Code of Best Practice for MMFs whose statements are in line with the recommendation done : limiting amortization to CDs/CPs and not FRN, limiting to papers with maturity below 3 months, materiality of a 10 basis point threshold that can force to adjustments in the portfolios.

We fully agree that 'responsible entities should ensure that assets of the collective investment scheme are valued according to current market prices, provided that those prices are available, reliable, and up-to-date'. CDs/CPs that have maturities below 3 months are generally 'buy and hold' holdings. As those instruments are not frequently traded on the secondary market there is no relevant active market price. For such investments we are in favor of implementing an amortized cost method.

To make sure this methodology is not creating discrepancy between NAV published and value of the assets, valuation of the portfolio should not deviate for more than 10 basis points. If it is the case adjustments in the portfolio must be done.

Recommendation 5: MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the funds accounts.

AFG fully agrees with this recommendation that will be stated in its Code of Best Practice.

Recommendation 6: Money market funds should establish sound policies and procedures to know their investors.

AFG fully agrees with this recommendation that will be stated in its Code of Best Practice.

Recommendation 7: Money market funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.

AFG fully agrees with this recommendation that it plans to state in our Code of Best Practice. AFG position would be to have a distinction between Short Term MMFs and MMFs like below:

- STMMF : 10% overnight and 15% one week
- MMF: 10% overnight and 15% one month

AFG has a firm position on what to be considered as a "Liquid Asset" considering the effective maturity of the investment. This include therefore:

- All CD/CPs maturing
- All reverse repos with 24/48 call
- Shares of money market funds

This should NOT include: Tbills with longer maturities.

Recommendation 8: Money market funds should periodically conduct appropriate stress testing.

AFG fully agrees with this recommendation that it plans to state in our Code of Best Practice do be done at least on a monthly basis.

Recommendation 9: Money market funds should have tools in place to deal with exceptional market conditions and substantial redemptions pressures.

AFG's position is to have the same tools as for UCITS and we therefore are waiting for the options to be precise after the European Consultation called 'UCITS VI'.

Recommendation 10: MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/ variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV MMFs' resilience and ability to face significant redemptions.

No Comment

Recommendation 11: MMF regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings.

AFG fully agrees with this recommendation that it plans to state in our Code of Best Practice in order to oblige French money market funds asset managers to set up a process, transparent for clients and approved by a third party.

Recommendation 12: CRA supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds.

AFG has no position on that point as it is the clients role to seek or not for a rating. Obviously French asset managers are not in favor of rating their MMFs if they have no client's need for this type of products.

Recommendation 13: MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss.

This point is already set up in the French legislation as in the prospectus the facts that there is no capital guarantee must be written. We also have instruction from French regulator how to explain performances with negative yield impact in the prospectus.

Recommendation 14: MMFs' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.

AFG fully agrees with this recommendation and think it is in line with improvement of the documentation via the 'KIID'.

Recommendation 15: When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by money market funds, taking into account the outcome of current work on repo markets.

French MMF managers are only doing reverse repo with high quality collateral. There is in most of the case a short maturity or a 24/48h call. Most of them are using Global Master Repurchase Agreement contracts to deal with type of collateral and margin call. This is in line in our view with the target of the IOSCO recommendation.

STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING

A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

General comments

First of all, AFG wants to draw attention to the following:

- Asset management is a highly regulated and closely supervised industry which does not create systemic risk; more specifically MMFs which are not in the scope of the present document are regulated in terms of maturity, liquidity, credit risk, and absence of equity or FX risks.
- Contrary to the banking industry, there is no leveraging of balance sheets in the fund industry: asset managers run the money clients have entrusted them with; leverage higher than 3 is exceptional and refers mostly to hedge funds.
- Maturity mismatch of ETF or credit funds should not be overestimated: it is in all cases an essential part of the fund manager duties to monitor the transformation risk and avoid illiquid assets and does not exist at all for synthetic ETFs.
- Eligible collateral has to be analyzed in the context of the coming regulation on derivatives (EMIR and Dodd Frank Act) in a flexible approach that might not create market disruptions; a solution consists in allowing a large list of eligible collateral together with appropriate haircut; furthermore it should be authorized for counterparties to agree on re-use of collateral.
- Funding through wholesale repo might be further analyzed as it appears as a place where systemic risk might appear.
- Transparent pass-through securitization of a portfolio of loans should be encouraged, but structured securitization relying on a Special Purpose Vehicle that refinances itself autonomously should be regulated as bank intermediation is.
- The technique of swing pricing should be considered as an efficient tool as it transfers the market impact of a large redemption order on the redeemer.

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?

First element, "the framework of five economic functions (or activities)"

As described in the framework, the approach of WS3 seems consistent with FSB's general view on Shadow Banking (SB): not a question of absence of regulation, but of credit and duration transformation.

We agree with the approach to focus more on the underlying economic functions rather than on the legal names or forms in order to avoid arbitrage from one product to another one. The 5 economic functions that have been identified provide a better framework for analysis than the list of entities mentioned in the introduction, which wrongly includes many activities of asset managers.

But we have strong reservations with a number of the examples provided in the Consultation Paper as the fact of providing examples of entities engaging in those activities, although useful for illustrative purposes, is in contradiction with the general approach proposed by WS3 stating that competent authorities should define shadow banking entities on the basis of the economic functions they perform rather than on their legal type or names.

By providing these examples, the risk is also to narrow the focus of the competent authorities on these examples only and therefore, to disregard or pay insufficient attention to other types of entities engaging in the same type of activities.

Second element, "the framework of policy toolkits"

The tool list, as explained, has to be implemented in a manner proportionate to risk incurred and to preliminary costs/benefits assessment in order to avoid unnecessary or inefficient regulation, together with a specific attention to existing local regulation in order to avoid market disruptions.

The possibility for 'optional policies' might reach to disequilibrium from one country from another in the same EU. Therefore we think it is important that interpretation from different country point of views should also not bring to different interpretation.

Third element, "information-sharing"

We agree that we need more transparency and agree to share data with authorities if they can be exactly the same and maybe only monitored by a high-level European authority. "Information sharing" looks as a flexible and efficient enough tool to track regulatory arbitrage and spot grey areas resulting either from regulatory loopholes or constant innovation.

Concerning the risk of regulatory arbitrage, it will largely depend upon the effectiveness of the implementation of the proposed policy tools at national level. The risk of regulatory arbitrage would obviously be more prevalent in case of significant divergences in regulatory and/or supervisory standards among jurisdictions and also between different financial sectors. Against this background, we do believe that the effectiveness of the information-sharing process across jurisdictions will play an essential role in minimizing regulatory arbitrage opportunities.

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 global feeling when reading section 2 is that many examples do not evidence specific risks of SB but refer much more to market risks in general. Maturity mismatch may be problematic but is not in all circumstances: in the fund industry it is part of the asset manager's task to follow both liabilities and assets and to adapt the profile of investments to the expectations of investors.

It appears also that the excessive use of some techniques has led, or might have led, to systemic risk. Typically excessive leverage is hazardous and should be controlled in funds (2.1), in securitizations (2.5), in the balance sheet of insurance providers (2.4) or of brokers (2.3) relying on short term refinancing.

In case of extremely adverse market conditions (as mentioned, for credit, in the third and last bullet point of §2.1) it is common sense to expect unexpected comportments and to fear “runs”. It is not the manifestation of an intrinsic failure of a SB activity, but relates to the essence of markets and human behavior.

At the end, the most specific area of risk stemming from SB is wholesale financing mainly through Repo. Few counterparties understand that they may participate to excessive leverage when they refinance assets through Repo or authorize their custodian to re-hypothecate their holdings.

These comments are designed to evidence that regulators have already developed tools to address most of these issues that are common to banks and non-banks. However, the diversified activities of hedge funds, which are probably among the most active participants, should be specifically analyzed and mapped as they may touch in some cases on several economic functions in a way that is not additive but multiplicative in terms of risks.

2.1 Management of client cash pools with features that make them susceptible to runs.

- *Credit investment funds (or mutual funds or trusts) that have a cash management or very low risk investment objective:* we understand that this point is to be solved as authorities, following IOSCO recommendations, are in the process of working specifically on MMFs, but also as they take into account the fact that all forms of MMFs proposal or similar should be covered by regulator.

- *Credit investment funds (or mutual funds or trusts) with external financing or substantial concentrated counterparty exposure:* we understand this covers the funds with leverage and also this is well covered now in new or coming legislation at the EU level.

- C*redit investment funds (or mutual funds or trusts) with significant holdings in the credit markets or particular segments of the credit markets:* the collective European asset management industry is tightly regulated both at the activity and actor levels with materially reduced non-financial risks. The regulatory framework in place concerning investment funds and their management entities is sufficiently ensuring the protection of investors’ interests and at the same time preventing the creation of systemic risks and implications. Leverage effect, maturity and liquidity transformation as well as credit risk exposure are tightly limited. In this respect, it must be stressed that any uncontrolled risks coming from the excessive use of techniques, which are neither limited nor monitored, cannot incur in UCITS funds or nationally regulated and monitored soon under the AIFM Directive.

2.2 Loan provision that is dependent on short-term funding

First we want to stress that such credit intermediation activities generate benefits for the financial system and real economy, for example by providing financing/funding to the economy and by creating competition in financial markets that may lead to innovation, efficient credit allocation and cost reduction.

Some examples presented in the report evidence that fraud is to be fought against. It is a general truth that is not limited to SB. The last bullet point of §2.2 refers to by-passing (a mild world for violating) existing regulation. Also, the local legislation in some countries, like France, has already decided to limit to banks (or financial institutions regulated similarly to banks) the possibility to receive deposits (cf. first bullet point in §2.2) or extend loans.

2.3 Intermediation of market activities that is dependent on short-term funding or on secured funding of clients assets

No comment.

2.4 Facilitation of credit creation

Similarly erroneous appreciation of risk leading to mispricing looks more like a traditional operational risk than a risk specific to SB. All §2.4 argument against credit enhancement relies on the mispricing of credit insurance by mono-line companies or mortgage insurers. The role of Credit Rating Agencies in this process should not be overlooked: their wrong-appreciation of risk led to wrong rating and logical mispricing, with the help of a regulation too heavily dependent on ratings. It is not a matter of regulation (except for the deletion of references to ratings) or control but of professional skills.

2.5 Securitization and funding of financial entities

The emphasis is done on ETFs (both physical and synthetic) which allegedly accept illiquid collateral from banks to cover counterparty risks involved in securities lending or derivative transactions. In this context, we wish to draw the attention of the FSB to the fact that in Europe the vast majority of ETFs are launched as UCITS and therefore are subject to the tight UCITS regulatory framework. Since July 2011, UCITS engaging in derivative transactions (including Total Return Swaps common used by synthetic ETFs) are required to accept only liquid collateral.

In its recently adopted guidelines on UCITS ETFs and other UCITS issues, ESMA decided to extend this requirement to securities lending and repo transactions. These guidelines will become effective in February 2013 and prescribe the following in terms of liquidity of the collateral: “Any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation” . It is therefore our understanding that the risk of liquidity transformation identified by the FSB with respect to ETFs may be seen as largely irrelevant for European ETFs (as well as all other UCITS).

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.

Please see below some questions and suggestions about Annex 1.

1. Maturity transformation:

Why comparing original maturity of asset/liabilities to outstanding maturity by buckets? Is the comparison of weighted–average remaining and original maturities not enough to appreciate the portfolio? Is the reference to original maturity relevant? For the facilitation of credit creation, the expected data on maturity transformation may not be pertinent for insurance companies. For securitization, early redemptions profile is of interest to estimate the expected maturity.

2. Liquidity transformation:

The definition of "liquid" assets should not rely on a legal differentiation of the market on which they trade: OTC markets are very liquid in many instances. The criterion might be relevant for equities, but for most other instruments, the size of the bid-ask spread is probably more relevant.

For loan provision, the support of the parent company has to be defined: does it cover credit facility, guarantee, letter of comfort, investment in bonds or CP or ABCP..?

3. Imperfect credit risk transfer:

"Off balance sheet exposures by instruments" is not explicit, as we only consider credit risk and it is difficult to find other instruments than CDS. "Risk weighted figures" implicitly refers to application of banking regulation and it should be discussed whether it is more satisfactory than gross figures.

In terms of challenges related to the collection or provision of information to the supervisory authorities, we wish to underline that most European investment funds, be they UCITS or nationally regulated funds, already provide comprehensive information to the authorities, their investors and the wider public.

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 report explains that this toolkit is a list of possibilities and not a catalogue of measures to implement. AFG's opinion is that application should be selective and appropriate. It shares this appreciation. Indeed, different contexts may impact, even within a common market like Europe, local regulations.

1. Management of cash pools susceptible to runs

For asset managers and most of all for those running money market funds, many tools are self-evident: a manager will not take risk inconsistent with the funds objective and this consistency is closely monitored by a team dedicated to risk control. ESMA, formerly CESR, issued rules on total and average maturities, both WAL and WAM, of money market funds. Leverage is also strictly limited for UCITS in general and Money market funds in particular. Eligible assets in UCITS must be liquid and liquidity buffers are considered as good practice in MMFs' management.

Diversification is a key factor too. But there may be situations where it is better to concentrate on liquid holdings than to diversify in less liquid ones, since, in case of stress, less liquid instruments become totally illiquid and more liquid ones may take advantage of a possible run to liquidity (often accompanied by a flight to quality). Nevertheless, rules of diversification like the 5/10/20/40% ratios of the UCITS directive in Europe proved to be adequate. But it would be inadequate to require, for example, diversification across different sectors as, in practice, it is not possible to achieve when issuers are mainly banks on the shorter end of the yield curve. To demand diversification would prompt inadequate pricing of second rank corporates who will be able to issue paper simply because large funds will be required to diversify their holdings.

Some tools for managing redemption pressures should be considered as a legal possibility which has not to be specifically mentioned or detailed in the prospectus of the fund and should be activated by the manager, when other tools should be totally in the hands of the manager and clearly described in the prospectus. Suspension of redemptions belongs to the first category. Redemption gates and redemption fees belong to the second category. The common idea is to make sure that all funds clients are treated fairly.

Side pocketing should be considered as a mean to exit the period of suspension of redemptions. Except for alternative funds that do not offer redemption on demand but impose both a notice period and monthly or quarterly redemptions and subscriptions, side pocketing should not be described in the prospectus nor implemented without prior approval by the competent authority.

The technique of swing pricing should be considered as an efficient tool to prevent redemptions in stressed market conditions. It transfers the market impact of a large redemption order on the redeemer as the NAV will be based on bid prices if there are net redemptions. It is a permanent device and there is no signal to the market the day it is enacted. It is flexible enough to take into account the fact that bid/offer spread enlarge.

2. Intermediation of market activities

Asset managers are concerned by the suggested restrictions on use of client assets. They agree with the requirement for segregation and the ban on using clients assets to finance own account’s business. The provision that the client may authorize the intermediary to re-use or re-hypothecate its assets is of prime importance. It brings some flexibility which may be necessary in some types of deals in the framework of the coming regulation, EMIR in Europe and Dodd Frank in the US, on derivatives and their collateralization.

3. Facilitation of credit creation

Buy side’s industry generally favors the principle of risk sharing and considers that the model of “originate to distribute” failed mainly because of the lack of risk sharing, through retention of first level risk, among all participants. They feel that insurers are sufficiently regulated and supervised to avoid any new mispricing, largely due to an over-reliance on credit rating agencies.

4. <u>Securitization and funding of financial entities</u>

On the question of maturity transformation through securitization, it is important to separate two types of securitization structures.

On one hand some transactions are done to transfer a portfolio of loans to investors that will bear the risk and receive the profits; there is no transformation in that type of transaction even if the slicing of the structure allows short term tranches to diverge from the average maturity of the portfolio. Overall it is totally transparent.

On the other hand some transactions offer a facility to refinance loans through an intermediary structure that will issue short term paper to finance longer term loans. It was regulated through the requirement that the structure be able to refinance in any circumstances thanks to a confirmed credit line. The credit line shorter than 365 days was risk weighted 0% and …excessive cheapness led to excessive refinancing. Transparent one-shot transactions should be encouraged and complex structures with reloading and/or conduits issuing CP should be prudentially regulated.

On the question of eligible collateral, the collateral that is posted should be carefully analysed in favor of any of the fund it manages. The fund manager may dismiss proposed collateral and demand appropriate securities or cash as collateral. Illiquid assets are not considered as eligible and as a general rule should be financed by own capital. However we consider that it would be counterproductive, especially with the implementation of EMIR and Dodd Frank Act, to limit eligible assets to a short list of a few issuers that would apply to all types of transactions with CCPs, banking counterparties and non-bank counterparties. It prefers to allow for a wide range of eligible collateral with an appropriate level of haircut.

More than restrictions on exposures, authorities should regulate the process of securitization: in order to make sure that originator will not lower its standards for lending, a significant and unavoidable risk retention should be mandatory; in order to avoid leverage, synthetic securitization should be prohibited, except as a total back to back transaction. In order to avoid excessive funding through securitization any underlying loan should only be financed once in only one securitization pool…these rules would be more efficient and could help to restore confidence in securitization. In that respect, the Prime Collaterised Securities label supported by Association for Financial Markets in Europe is a good initiative.

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.

Yes we think there is an additional cost if authorities are not able to work with an existing reporting. But we also want to highlight that reporting data is not principal activity for asset managers and development, implementation and updating a lot of data can lead to distorted information. This might be most of all the case in the actual situation where this industry is facing strong changes and crises.

The AIFM Directive coming into force in July 2013 will bring the quality of supervisory monitoring to an even higher level by imposing ambitious reporting requirements on managers of alternative investment funds. Supervisory reporting will be mandatory for most AIFs on a quarterly basis and will include detailed information on portfolio composition, principal exposures and most important concentrations, risk profile and liquidity management. The AIFMD reporting will also provide helpful data for assessing the interconnectedness between banks and other financial entities. These requirements have been developed with the specific aim of enabling supervisory authorities to effectively monitor systemic risks associated with AIF management.

The AIFMD reporting requirements are unique in the EU financial sector as regards their frequency and effectiveness. Their implementation by mid-2013 will present a huge challenge for European fund managers, both in operational and financial terms.

Against this background, we deem it essential that any new reporting requirements stemming from the FSB recommendations on shadow banking be integrated into the existing reporting systems for investment funds and no separate reporting procedures be established for these purposes. As far as the AIFM regime is concerned, this should prompt a refinement or possibly modification of the focal points of reporting with a clear view to avoiding excessive costs and operative burdens for the industry.

STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING

A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

General Comment:

As properly mentioned, so called (improperly to our view) “shadow banking” (SB) is not per se to be considered as delinquent and/or dangerous: it brings real contribution to finance the economy providing liquidity in the market, and it is more the excess of repo and securities lending that can prove dangerous than its essence.

Asset management should be considered with specific care, as it is a highly regulated activity and closely supervised by specialized national, regional and international regulators; in particular UCITS developed under the European legislation present all qualities to be considered as free of any systemic risk. For the non UCITS European funds, AIFM directive level 2 is entering in force in 2013.

Many questions relating to potential dangers created by re-use and re-hypothecation should be addressed keeping in mind the legal framework of securities law: contrary to some countries, in continental Europe there cannot be any creation of stocks or bonds through re-hypothecation or re-use as securities law demands a permanent equivalence between the number of shares issued and that kept in custody for the account of all holders in all custodians.

Generally, we fear that the buy side’s reasonable use of repos or securities lending might be very much harmed by a ill crafted regulation attempting rightly to refrain the excessive and risky attitudes that the fund management industry never can nor wishes to adopt. Those management tools are used by asset managers for a couple of decades now: therefore regulation covers all excess that could come from this type of leverage.

Indeed, most if not all of the financial stability issues described in the document are already within the scope of several European directives and regulations, such as MIFID, MIFIR, EMIR and MAD. Those directives and regulations have or will soon enter in force in the EU and answer the FSB concerns. Additional recommendations/regulations may lead to negative pro-cyclical effects for European participants.

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.

Concerning the financial stability risks in the security lending and repo market we would like to highlight that the practice for the European Asset Management industry is already heavily regulated, so the risk is far less significant than developed in your reports. Please see below the explanation for Repos/Reverse repos and Securities lending developed by ESMA trough the new guidelines for UCITS products.

<u>Repos / Reverse repos:</u>

Repo and reverse repo arrangement provide a very safe, flexible and profitable investment. The investment limit to 100% of the funds NAV prevents any excessive leverage. Reverse repos are one of the most commonly used money market operations for funds. They are contractually well-defined and implemented so as to reduce and control legal and operational risks. In general, reverse repos are used with a call enabling the fund to get its securities back without delay.

Reverse repos are an integral part of a money market fund (MMF) normal dealings, especially so for "government MMFs" (MMF's whose investment policy only allows government securities). They represent about 5% - 15% on average in portfolios, and more in government MMFs. French MMFs use only very short term callable (24h/48h) reverse repos entered with selected MMF eligible counterparties.

Reverse repos offer a very useful, flexible and safe financial instrument in MMFs. For a given counterparty/issuer, they are safer than other typical MMF investments. For example, it is safer for an MMF to engage into a reverse repo transaction with Bank XYZ where the MMF buys financial assets, pays the price and receives or pays variation margins, as opposed to just buying a CD for that same Bank XYZ without any guaranty such as collateral.

As suggested by stakeholders, ESMA decided to introduce the possibility of cash (in the context of reverse repo) to be recallable on a Marked to Market basis and not only on an accrued basis. It was agreed that when cash is recallable on a Marked to Market basis, the reverse repurchase agreement should also be valued on a Marked to Market basis for the purposes of the calculation of the net asset value of the fund. Also, ESMA clarified that both overnight and fixed-term arrangements up to 7 days should be considered as arrangements under which assets are recallable at any time.

A UCITS fund that enters into a reverse repurchase agreement should ensure that it is able at any time to recall the full amount of cash or to terminate the reverse repurchase agreement on either an accrued basis or a mark-to-market basis. When the cash is recallable at any time on a mark-to-market basis, the mark-to-market value of the reverse repurchase agreement should be used for the calculation of the net asset value of the UCITS.

<u>Securities lending and cash collateral reinvestment:</u>

UCITS employing efficient portfolio management techniques have to make sure that the risks arising from these activities are adequately captured by the risk management process. The liquidity risk management process in place ensures they are able to comply at any time with their redemption obligations.

All collateral used to reduce counterparty risk exposure should comply with the following criteria at all times:

a) Liquidity: any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation.

b) Valuation: collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.

c) Issuer credit quality: collateral received should be of high quality.

d) Correlation: the collateral received should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty.

e) Collateral diversification (asset concentration): collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration considers a maximum exposure to a given issuer of 20% of its net asset value.

f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.

g) Where there is a security transfer, the collateral received should be held by the depositary. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.

h) Collateral received should be capable of being fully enforced at any time without reference to or approval from the counterparty.

i) Non-cash collateral received should not be sold, re-invested or pledged.

j) Cash collateral received should only be:

- placed on deposit;
- invested in high-quality government bonds;
- used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the investor is able to recall at any time the full amount of cash on accrued basis;
- invested in short-term money market funds

Securities lending is rightly recognized as a legitimate activity which benefits investors by reducing costs and contributing to the performance of the fund. Investors are informed of the use of stock lending techniques as well as any efficient portfolio management technique in the prospectus of the funds.

This prospectus includes a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments has to be in line with the best interests of the investors.

Moreover, UCITS have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a 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.

Finally, the counterparty risk created in a UCITS fund by EPM techniques is added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive. The new ESMA Guidelines on UCITS limit the counterparty risk from EPM techniques to 20% of the net asset value per counterparty. EPM techniques are also included in the leverage.

The current practices imposed by ESMA to the UCITS universe are already highly regulated. It would not be efficient to add a new layer of rules.

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?

AFG agrees with the fact that transparency could and should be improved. For all types of operations (with tri party or bilateral), the concern is on the lack of transparency at a Macro-level market data. In the absence of centralized securities financing markets and due to the bilateral nature of securities financing transactions, the most appropriate transparency would be through a centralized post-trade reporting.

This reporting, would allow market participants to have a good overview before entering into a transaction and to obtain a more fair value price for them and for their clients. Asset managers would therefore also benefit from the transparency provided by banks.

This issue is under the scope of MIFID and MIFIR in Europe. If different reporting were to be implemented, AFG fears that too much reporting per trade meaning higher trade costs would reduce clients return.

Also, in our opinion the best practice is to focus on the operational risks management on securities lending /repo, namely:

1. the choice of counterparties
2. the eligible collateral matrix
3. haircuts applied to different collateral types
4. daily valuation of lent securities and collateral received on the basis of reliable market prices
5. margin calls that may be applied on a daily basis if needed
6. collateral segregation at the custodian at fund and counterparty level
7. a prudent framework regarding a potential collateral reuse.

Therefore AFG agrees with recommendations that would introduce minimum standards in the practice of repo and securities lending.

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?

Please to refer to the question 1 and 2 above.

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.

If different reporting were to be implemented, AFG fears that too much reporting per trade meaning higher trade costs would reduce clients return. This is almost true actually in a context of very low short term return. The implementation of all reporting should be coordinated in order to reduce this cost.

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)?

Key principles (expressed page ii of the Preface) to proportionate the burden of regulation to the level of risk and to introduce a threshold of materiality are essential to develop appropriate regulation.

Recommendations on repo and securities lending should anticipate the coming impact of new regulations, namely Dodd Frank Act in the US or EMIR in Europe, on derivatives that will impose an extended use of collateral; in order to get eligible collateral some investors will have, when they do not hold such eligible assets, to enter in collateral swaps that will themselves be submitted to collateralisation with (unavailable by hypothesis) eligible assets: thus re-use may simply be a necessity.

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.

A UCITS has to inform investors clearly in the prospectus of its intention to use the techniques and instruments referred to in Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. Indeed, a UCITS includes a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments provide the best protection of the investor and a robust follow up of the activity.

An annual report which contains the details of the following provides a sufficient level of information for the investors:

a) the exposure obtained through efficient portfolio management techniques;

b) the identity of the counterparty(ies) to these efficient portfolio management techniques;

c) the type and amount of collateral received by the UCITS to reduce counterparty exposure;

d) the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred

The UCITS has to disclose in the prospectus the policy regarding direct and indirect operational costs/fees arising from efficient portfolio management techniques that may be deducted from the revenue delivered to the UCITS. These costs and fees should not include hidden revenue. The UCITS should disclose the identity of the entity(ies) to which the direct and indirect costs and fees are paid and indicate if these are related parties to the UCITS management company or the depositary.

We want to highlight that in the French regulation NON-UCITS have equivalent rules.

Therefore, any request made by a national or the European regulator may lead to specific report of an activity. AFG wants to emphasize the need to refer to reporting that are about to be introduced in local regulations, like EMIR in Europe, before deciding the relevant items. It should be coordinated and avoid differences.

We see two specific comments on items listed in box 1:

- Securities available for lending is not a relevant concept as it is not defined and potentially all securities are available for lending.
- Ultimate counterparty should not be disclosed as it would break the confidentiality duty of the intermediary towards its client.

The level of granularity to be achieved at firm level and on aggregate data has to be determined more precisely. It sounds very detailed in order to make the indication of repo or lending rates significant or to specify the rules for re-hypothecation.

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?

Compared to official surveys and regulatory reporting, Trade Repositories (TRs) represent an effective way to collect data. However, regulators should be concerned by (i) not imposing heavy additional costs on market participants that ultimately will impact returns for final investors and (ii) serious data cleansing issues unless regulators plan to obtain data from each participant in the market and perform the data matching. Geographically, it sounds useful to reduce fragmentation: one (and not several) TR for one currency zone. The FSB at a worldwide level and the ESRB at the European level could be the authorities the most qualified to establish such studies.

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?

It needs to be very clear exactly what level of information is required. Clearly the repo market is massive, with substantial volume, though to be fair still the vast majority is transacted within one week. Transparency is important but too much information to be trawled through may end up being more of a hindrance. There needs to be a clear goal as to what is required. It is also important that there are no geographical loopholes or difference in treatment, thus causing potential arbitrage.

Cost and delays for implementation are significant as for any reporting on large quantities of data with many different counterparties: IT developments will be necessary requiring of a minimum of 2 years after final regulation has been published. A phasing parallel to EMIR implementation delays is a good option, especially if contents can be unified.

We support the introduction of TR. They are the only way to get the information whatever is the entity, or its regulation. However we suggest the industry to be 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 harmonized approach should be adopted to avoid any regulatory arbitrage from one jurisdiction to another.

Alignment and rationalization should be sought with (regulatory and central bank) authorities as many surveys are already in circulation, asking often very similar data and magnitudes

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.

Considering the annual report described in question 6 above, we do not see the added value of a more frequent or more detailed disclosure of the identity of the counterparties or more details on the efficient portfolio management transactions.

Asset management is directly concerned by recommendation 5 and should not be submitted to different reporting to the holders of the funds and to regulators (under recommendation 4).

A dual approach might be more appropriate. A set of higher detail disclosure elements might be shared with the regulators (including percentage of collateral pool re-used), whilst a more summarized format would be disclosed to the broader public.

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.

The list of items listed under §2.4 is not relevant to funds in general. A line should be drawn between hedge funds and retail products such as UCITS in Europe. Disclosure should be much more detailed for hedge funds that use repos and securities lending as a technique to arbitrage markets and to refinance. UCITS that cannot hold an exposure to markets higher than 2 for 1. For example, Money Market funds doing reverse repo on short date should not report systematically.

Hence, it is very clear that under the UCITS framework securities lending and repos cannot be used for building up leverage in the fund's portfolios. Moreover, the new ESMA guidelines for UCITS already introduce reporting requirements to investors in relation to the exposure obtained through securities lending and repo trades, the identity of counterparties, the type and amount of collateral received by the UCITS and the revenues arising from these activities together with operational costs and fees incurred. In our view, these reporting items are fully sufficient to account for the information needs of retail investors and must not be further enhanced or refined based on FSB's recommendations.

We agree that fund investors should get disclosure regarding securities lending and repo activity that is consistent with the disclosure standards applied to other investment activities of the same fund. However, we disagree that a list of specific counterparties is useful information for fund investors. Clearly, the details of reporting contemplated by WS5 are far too sophisticated for retail investors and cannot be reasonably expected to have any controlling impact on the retail markets.

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?

In order to avoid procyclicality, haircuts should not be subject to reassessment and should remain stable. It should not be overlooked that when regulating haircuts, we refer to risk of the third level: initial risk lies with the counterparty of the reverse repo, second level risk is in the quality of the securities received and third level relates to haircuts. This remark prompts to a stable prudent and standardized approach to haircuts. Focus should be directed on the proper and regular valuation of securities received and their immediate legal availability in case of need.

UCITS have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a 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. As the determination of an haircuts vary from one market situation to another, and from types of issues and not only to the type of issuers, it is therefore hardly possible to define a proper minimum haircuts that would feet to each kind of products. Doing it as it is done actually with a specific process is still the best practice to do it.

We believe that there will be more overall benefit from mandating a robust daily mark-to-market process using independently-established valuation as suggested in Recommendation 11 than from requiring a minimum haircut without robust processes. We also fear that the suggested factors to be taken into account for setting risk-based haircuts are in our opinion very ambitious.

Each UCITS, receiving collateral for at least 30% of its assets, engages appropriate stress testing policy to ensure regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS to assess the liquidity risk attached to the collateral.

The liquidity stress testing policy includes at least the following:

a) design of stress test scenario analysis including calibration, certification & sensitivity analysis

b) empirical approach to impact assessment, including back-testing of liquidity risk estimates;

c) reporting frequency and limit/loss tolerance threshold/s; and

d) mitigation actions to reduce loss including haircut policy and gap risk protection

When entering into EPM arrangements, a UCITS takes into account liquidity considerations in such a manner as to ensure that such arrangements does not compromise its ability to meet its redemption obligations in accordance with Article 84 of UCITS directive.

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?

The fact that the proposed schedule does not refer to any rating is positive to fight over reliance on rating agencies. On the other hand, it reduces the possibilities to develop a better granularity and accept lower haircuts on better assets.

Worth noticing also the look-through approach for funds, which would only be workable on the basis of a monthly reporting and with some delay. The alternative to refer to the worst possible case is too stringent and should allow for neutrality on assets that cannot exceed 10% of the Net Asset Value.

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?

It is not possible to express a view without taking into account the scope of the numerical haircut framework: for some entities or activities one or the other of the two options or a full exemption (see footnote 13 on page 16 concerning securities lending and cash collateral) might be better adapted.

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

In our opinion, the most important characteristics of assets eligible as collateral are liquidity and proper up-to-date valuation. Asset classes featuring high liquidity and subject to reliable valuation should be assigned comparatively low minimum haircuts.

We are not convinced that numerical haircut floors are the exact answer. For the more illiquid collateral buckets, we would think current market haircuts should suffice.

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?

The reference (page 14) to the schedule proposed by the BCBS-IOSCO working group on margining requirements (WGMR) for non-centrally cleared derivatives and to Basel 3 requirements is important as consistency throughout different regulations is essential for market participants.

AFG suggests that a two level approach should be considered. On one hand, the proposed schedule should be considered as a standard approach conceived as prudent, and on the other hand it should be possible to overrule it by reference to a model approach based on models approved by the concerned regulator. This two way approach would offer both strict minimum rules and flexibility (subject to approval). However when a model has been agreed upon by one regulator it should be eligible for its counterparties, even if they are regulated by another authority.

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?

AFG supports WS5 analysis that only transactions aiming at refinancing and developing high leverage should be subject to haircuts numerical floors and that cash collateralized securities lending should be left out of scope. As soon as they participate to a refinancing transaction that will bring high leverage, collateral swaps should also be subject to floors.

The discussion about the opportunity to introduce minimal regulatory haircut on sovereign bonds is effectively relevant as it refers to state sovereignty, a key political issue, and to currency supervision, another key political issue, especially in the framework of a currency union with a single central bank as the Eurozone.

The notion of risk free interest rate applies to the best (one or a small number of homogenous countries) of all countries constituting the zone; all other sovereign bonds present a spread.

Our suggestion would be that sovereign bonds should not be included in the scope of standard regulatory haircuts but should be accepted with the same rules as applied by the central bank which accepts them for refinancing. Procyclicality or not would hence be in the hands of the central bank and there would not be room for regulatory arbitrage.

On the contrary, AFG does not share the analysis conducted on the counterparties as it only divides the world in two sides: prudentially regulated financial entities and other entities. That last part cannot be considered globally without taking into consideration the level of risk they may generate.

More specifically funds with low leverage (less that 3:1) although not being prudentially regulated entities are strictly regulated and closely supervised entities that bring no significant risk as their capital cannot be exposed more than 3 times to market variations, what arguably represents a minimum capital requirement of 33%, far higher than anything applying to banks and prudentially regulated entities. It is of prime importance that counterparties are analyzed according to both the degree of regulation and supervision they are subject to and the level of leverage they are allowed to reach.

Transactions with non-regulated or quasi-non-regulated entities should be the priority for the application of numerical floors. Transactions between banks should be submitted to haircuts according to either their internal models or the standard minimum approach, depending on their degree of sophistication. Transactions between banks and non-banks should be subject to haircuts according to banks policies (indirect regulation) and take into consideration the specific case of non-regulated counterparties.

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.

AFG would remind that considering the framework for regulated funds, they should remain outside the scope of the regulation. A way to deal with difficulties in the application of numerical haircut floors is to introduce carve-out provisions for these transactions. The case of cash collateral of securities lending has been outlined as an example where the transactions is led by the securities borrower who does not want to leverage and is ready to post high cash collateral.

Also, the use by governments of a variety of issues, from pledging margin to hedging tools could be a problem. The settlement of government bonds often gets extended. This is done frequently to bridge settlement timing gaps and cash flow gaps against purchases and sales of corporate and MBS positions that normally have settlement dates other than the standard T+1. Considering these extension in settlement, it is impossible to haircut a settlement date that has been extended. On a large scale, applying haircuts to these securities will make it operationally more difficult and increase failures in the system.

More generally it is of prime importance that entities such as low leverage highly regulated funds be outside the scope of the regulation, if there is any exemption at all.

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?

AFG would like to remind that margins are counterparty credit risk mitigation tools and are set and exchanged at client’s level.

Most often margins are set at the portfolio level and it is not possible to ask for any other approach, as the risk should be appreciated at the client’s level and not on the basis of one transaction isolated from the context. In that respect the use of models is common practice and should be encouraged. The numerical floors framework can be only one of two ways: regulatory minimum or internal model.

Calculations of haircuts being based on collateral posted, it is not a difficulty to first compute the level of collateral needed, including correlations and write offs, and then turn to the haircuts.

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?

AFG broadly agrees with the idea of expressing a policy of reinvestment of cash collateral. 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.

We consider that non-cash collateral received should not be sold, re-invested or pledged. Cash collateral received should only be placed on deposit, invested in high-quality government bonds, used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the investor is able to recall at any time the full amount of cash on accrued basis or invested in short-term money market funds. Re-invested cash collateral could be diversified with a limit of 20% per issuer.

However, we would submit some specific comments:

- Money Market funds should be expressly mentioned as highly liquid short term assets;
- WAM and WAL definitions do exist and, in Europe, it should be referred to CESR's regulation of Money market funds in May 2010 to be consistent;
- ESMA issued guidelines on collateral which are properly aimed at funds; they include a maximum concentration ratio of 20% and a stress test in case of collateral amounting to more than 30% of the NAV of a fund; that type of decision should be considered as fulfilling FSB suggestions and taking into account the materiality issue;
- Disclosure requirements as proposed are not adjusted to the reality of funds which have constraints of timely disclosure to holders and confidentiality; furthermore, illiquid assets are not eligible to most funds.

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

According to the proposed definitions (p22), asset managers are not in a position to re-hypothecate and are only concerned with re-use of securities. Effectively, they do not hold assets of their clients but manage portfolios in the best interest of the holders of the funds.

Nevertheless portfolio managers want to be able to authorize counterparties to re-hypothecate their assets in some well-defined circumstances, as it may reduce cost of some transactions and be in the best interest of holders. "No re-hypothecation without our prior consent" should be the rule. For re-use, AFG shares the view that it should be authorized as long as it does not lead to excessive leverage. Funds are closely risk controlled and the leverage is one significant ratio that is constantly monitored by dedicated teams within the asset management firm. Thus, there is no difficulty in assessing at first sight the level of authorized and realized leverage of a fund.

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?

AFG supports the recommendation of daily mark to market and the collection of variation margin for exposure to counterparties. We believe that this requirement would be a greater improvement to existing processes than a minimum haircut requirement. Access to securities received as collateral very much depends on applicable security and bankruptcy laws. A specific effort to improve securities law, in order to make it impossible to have more certificates in circulation than shares issued, should be on the agenda of FSB.

Minimum standards for valuation of collateral would be a positive step as it would greatly increase transparency in the market. If there were guidelines and processes to follow in times of a repo counterparty failure, this would also decrease pressures in the market.

Additionally, the requirement that "securities lending and repo market participants should only take collateral types that they are able following a counterparty failure to hold outright without breaching laws or regulations" (section 3.4 para. 1) should not imply an obligation for investment funds to accept only collateral compliant with their investment policy as defined in the fund rules or instruments of incorporation.

As a consequence, regulatory measures for investment funds focus in the first place at ensuring that the received collateral is of good credit quality, highly liquid and subject to frequent valuation in order to warrant the possibility of smooth disposal following the counterparty's insolvency. This approach has been recently endorsed by ESMA in its Guidelines for ETFs and other UCITS issues.

Counterparties should be authorized to value collateral and exchange margin calls less frequently than daily if they agree for higher margins and/or haircuts.

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?

CCPs are supposed to clear deals sufficiently standardized and liquid. That principle applies to derivative instruments and should apply to repos and securities lending transactions. The provisions of EMIR for mandatory central clearing include an assessment of these two criteria by ESMA, on top of the examination conducted in the process of authorization given by the local regulator to clear a new contract. This regulatory framework seems appropriate.

Safety of repos and securities lending is of prime importance and any envisaged modification to existing rules should be subject to extended consultation and worldwide impact assessment. There is no need to rush into changing bankruptcy laws. However, FSB and WS5 should prioritize the revision of securities law in order to make it impossible to have more certificates running than the number of shares issued. It proved to bring real confusion at the time of Lehman's failure and would be of great help in order to increase safety of financial markets at large and repos and securities lending transactions more specifically.