

CNMV ADVISORY COMMITTEE RESPONSE TO THE FSB CONSULTATIVE DOCUMENTS: 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

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References

1. The shadow banking system

1.1. Definition and importance of the shadow banking system

There are many alternative definitions of shadow banking. The Financial Stability Board (FSB) defines shadow banking as “credit intermediation involving entities and activities outside the regular banking system”, but other authors give complementary definitions that emphasize different aspects of shadow banking. For example:

- Adrian and Ashcraft (2012) say it is “a web of specialized financial institutions that channel funding from savers to investors through a range of securitization and secured funding techniques”.
- Poszar, Adrian, Ashcraft and Boesky (2012) put special emphasis on the similitudes and differences between traditional banking and shadow banking explaining that they carry out similar functions but that “shadow banks [unlike] traditional banks lack of access to public sources of liquidity such as the Federal Reserve’s discount window, or public sources of insurance such as Federal Deposit Insurance”.

Putting together these three definitions we can say that the shadow banking system is the network of financial intermediaries that conduct maturity, credit, and liquidity transformation without being subject to banking regulation and do not have formal access to central bank liquidity or public sector credit guarantees.

Among the financial institutions that comprise the shadow banking system we find money market funds (MMFs), structured finance vehicles, broker-dealers, finance companies and financial holding companies. The FSB also includes hedge funds and other investment funds in the shadow banking system.

The FSB has estimated that, globally, the shadow banking system represents on average 25% of financial system assets but there are marked differences across jurisdictions. For example, the importance of other financial intermediaries (OFIs) relative to the banking system is large in the US and the UK but it is only moderate in Germany, France, Spain and Italy¹.

1.2. The growth of the shadow banking system

Traditional banks issue these short-term deposits and invest the money in long-term assets such as loans, leases and mortgages.

Pozsar et al. (2012) describe the functioning of the shadow banking system as organized around wholesale funding through deposit like instruments and securitization of the long-term assets. In the shadow banking system, loans, leases, and mortgages are securitized and thus become tradable instruments. Funding is also in the form of tradable instruments, such as commercial paper and repo. Savers hold money market balances, instead of traditional deposits. To explain why this system has appeared we have to analyze where the demand and offering are coming from.

¹ FSB: Global Shadow Banking Monitoring Report 2012, p.13.

On the demand side shadow banking grows because of the demand for deposits like instruments (i.e. “informationally-insensitive” very short-term debt) from institutional investors to manage their cash-balances. Traditional banking works for retail investors but it is not useful to institutional investors. Corporate treasuries, banks, hedge funds, pension funds, mutual funds, states and municipalities etc., have the need to deposit large amounts of money for a short period of time, but they are not covered by deposit insurance. Gorton (2010) explains that there are three basic instruments of the shadow banking industry that satisfy this demand: MMFs, repos and collateralized securities issued by structured finance vehicles.

On the offering size there are two reasons why financial institutions are interested in shadow banking.

The first reason is the search for yield on the banks side. Over the last 30 years, as competition in the banking industry increased the banks substituted deposits for fee-based wholesale funding. Pozsar et al. (2012) argue that this process has transformed banks from being low return on-equity (RoE) utilities that originate loans and hold and fund them until maturity with deposits, to high RoE entities that originate loans in order to warehouse and later securitize and distribute them, or retain securitized loans through off-balance sheet asset management vehicles. Securitization can be valuable in different ways:

- Securitization involving real credit risk transfer is an efficient way to share risks. The loan originator (the traditional bank) can limit concentrations to certain borrowers, loan types and geographies on its balance sheet by transferring these loans to diversified investors.
- Securitization allows traditional banks to conserve capital (transform illiquid assets into cash and use cash to make more loans) and realize economies of scale from their expertise in loan origination and monitoring that are not possible when required to retain loans on balance sheet.
- Securitization is a valuable way to involve the market in the supervision of banks. It can provide third-party discipline and market pricing of assets that would be opaque if left on the banks’ balance sheets.

However, a second reason why financial institutions engage in shadow banking is trying to escape banking regulation and, in particular, capital requirements. Through the use of structured finance vehicles and financial holding companies banks were able to increase their leverage, which increased their expected returns but also their exposure to aggregate risks. Moreover this tendency was aggravated by the poor monitoring incentives provided in the origination phase in the new originate-to-distribute model and the distorted incentives that the system generated for the rating agencies that had to certify the quality of the securities being used as collateral.

1.3. The role of shadow banking in the financial crisis

All banking systems are vulnerable to panics: rational or irrational shocks that make deposits “informationally-sensitive”, and thus suspicious, and lead all depositors to withdraw simultaneously forcing banks to disrupt the long term lending activities. A systemic event is a panic that spreads through all the banking system making it insolvent.

According to Gordon (2010) the current financial crisis was triggered in August 2007 by a wholesale banking panic in the shadow banking system.

The current panic occurred when problems in subprime lending became apparent and, because of asymmetric information, investors could not ascertain the exposure of their counterparties to this problem and their solvency. Thus financial firms “runned” on other financial firms, withdrawing cash from MMF and/or not renewing repo agreements or increasing the repo margin (“haircut”). This forced massive deleveraging and resulted in the banking system being insolvent.

After the panic the markets for collateralized securities have become illiquid. Why? A panic is an event where informationally-insensitive debt becomes informationally-sensitive. It is a switch because it becomes profitable to produce private information about the debt. That is, some agents are willing to spend resources to learn private information to speculate on the value of these securities. This was not profitable before the panic. This leads to a “lemons market” in which everyone needs to suddenly produce information to trade. But market participants are not prepared to cope with the sudden information requirements for understanding, valuing, and trading securities that are suddenly informationally-sensitive. This makes them illiquid.

2. Regulating the shadow banking system

2.1 Reasons for regulating shadow banking

Before we look into the particular details of the regulation being proposed we should take a step back and ask whether there is a need to change the regulation of shadow banking activities. There are two reasons why shadow banking may need to be regulated.

- (i) The first reason is the possibility that the shadow banking system is used as a way to escape regulation and is used to do things that could be done under the traditional regulated system, increasing the probability of systemic events. For example, before the crisis many commercial banks created special investment vehicles and conduits to purchase the long-term assets of the bank and finance the purchase by issuing short-term asset-backed commercial paper (ABCP). Nevertheless the sponsors of the conduits (the commercial banks) were required to pay off maturing ABCP, thus offering a guarantee to the outside investors in these conduits. Therefore, there was no real risk transfer but the assets did not appear on the bank’s balance sheet, allowing the bank to over leverage and escape capital regulations. In these cases regulation is simple because these activities should be consolidated into the balance sheet of the traditional banking system.
- (ii) The second reason for regulating is that activities that are special and particular to the shadow banking system involve high leverage and maturity, liquidity and credit

transformation, and therefore make the shadow banking system, just like the traditional banking system, vulnerable to panics and systemic events. For example the “repo” works like a deposit for institutional investors, where there is no deposit insurance but there is an implicit guarantee arising from the high liquidity of the securities used as collateral. A panic may happen in this market if there are sudden changes in the credit rating of these securities. According to Gordon (2010) the current financial crisis was triggered in August 2007 by a wholesale banking panic in the shadow banking system. Problems in subprime lending became apparent and, because of asymmetric information, investors could not ascertain the exposure of their counterparties to this problem and their solvency. Thus financial firms “runned” on other financial firms, withdrawing cash from MMF and/or not renewing repo agreements or increasing the repo margin (“haircut”). This forced massive deleveraging and resulted in the banking system being insolvent. The potential regulation of this type of problem, discussed below is the most difficult and interesting.

2.2 Potential regulatory strategies

In the case of the activities that are particular of the shadow banking system the objective of the regulation should be to try to prevent systemic crisis and procyclicality of the financial crisis without increasing costs in normal time.

If the objective of the regulation is to prevent systemic crisis it is important to understand the underlying reason for these crisis. The seminal works of Diamond and Dibvig and Diamond show how banking crisis are started by liquidity shocks that make a large number of investors demand cash from their deposits. There may be many reasons for the shock. Some shocks may be exogenous (e.g. a war). But many times the shocks are endogenous, and they are caused by an increase in the asymmetry of information about the quality of the bank’s assets. Moreover, as pointed out by Bolton and Freixas (2006), economic crisis, which may be originated outside the banking system, tend to make the asymmetric information problem worst and may cause a credit crunch when credit is most needed, aggravating the crisis.

Therefore if we want to prevent systemic crisis we can use four basic types of regulation:

1. Regulation restricting the liquidity of the deposit like instruments. Possible policies include redemption fees or gates, suspension of convertibility, reforms of bankruptcy laws to make repos subject to “automatic stay” rules².
2. Regulation restricting the use of deposit like instruments to fund long-term investments. Possible policies include capital requirements, restrictions on the use of client assets and liquidity requirements such as the laddering of liabilities maturities.
3. Regulation reducing asymmetric information about the quality of the assets backing the deposits. Here we can distinguish between two different types of regulation that can be used to reduce asymmetric information in his context.

² The “safe harbor” status of repos and CDS in bankruptcy increases the “money-likeness” of these instruments. Currently they have the highest priority, higher than secured debt, because they are excluded from automatic stay in bankruptcy that applies to all other claims. CDS are executed even in bankruptcy and collateral collection in repos also continues during bankruptcy. This generates an implicit subsidy for these modes of financing.

- i. First, asymmetric information can be reduced by putting restrictions on the types of investments of these financial institutions, such as limits to the maturity of assets, limits on asset concentration, limits to investments with no secondary markets and liquidity buffers and restrictions on the types of assets that can be used as collateral.
 - ii. A second possibility for reducing symmetric information is to improve the risk-assessment of the assets being used through policies such as the use of coinsurance and deductibles imposed on investors seeking credit default insurance and regulation changing the incentives of the credit rating agencies (CRAs)³.
4. Regulation for dealing with systemic crisis once they occur. It is unlikely that even good regulation can prevent all systemic crises. Therefore part of the regulatory efforts should be directed at designing the best policies for dealing with the crisis once they occur, aimed at restoring the solvency of the system quickly and without imposing externalities on third parties. The solution to the current crisis has largely fallen upon uninformed taxpayers that had very little active part in the shadow banking system, and has destroyed the credibility of the regulator not to bail out institutions that "misbehave". Therefore it is very important to design good resolution mechanisms. These mechanisms can both reduce the costs of systemic crisis when they occur and reduce the probability of their occurrence by changing the incentives of the institutions to overleverage. These resolution mechanisms could include the use of contingent capital, the use of convertible debt to remunerate the managers of financial institutions and the design of special bankruptcy procedures for financial institutions that transform debt into equity by using options⁴.

2.3. Reflections on differences in regulation across jurisdictions. Regulation in Europe and Spain

On order to determine which of the potential regulatory strategies is more appropriate it is interesting to study the different current regulatory practices across regulations and to determine whether these differences in regulation explain the market differences in the importance of the shadow banking system across jurisdictions.

If we analyze more specifically the case of Spain, where the shadow banking system is very small, we can see that the existing regulation with regard to MMF, repo transactions and securitisation processes is designed to avoid "regulatory arbitrage" out of balance and systemic risks inherent in the use of these instruments.

In the case of MMF, the legislation applicable in Spain to Collective Investment Schemes⁵ (CIS) establishes that they must be marked to market (VNAV) and there is therefore no implicit guarantee that their value will be maintained. This legislation is a transposition of Community directives on money market instruments which prevents any liquidity risks. Consequently,

³ Interestingly the FSB is silent about the regulation of CRAs because they are not considered financial institutions. The interested reader can refer to Coffee, John C.(2010), Ratings Reform: The Good, The Bad, and The Ugly, ECGI - Law Working Paper No. 162/2010 for a discussion of the ideas on how to regulate CRAs on key issues such as disclosure, competition and pay model.

⁴ For a discussion of these mechanisms see Bolton and Scheinkman (2011), Bolton and Samama (2010) and Bolton, Freixas and Shapiro 2010.

⁵ CIS Act 35/2003 of 4 November, Royal Decree 1309/2005 of 4 November and CNMV Circulars 1/2009 of 4 February and 3/2011 of 9 June

Mutual Funds in a European environment have been able to meet subscriptions and redemptions adequately.

In addition, they do not need to be covered by a Guarantee Fund. Mutual Funds are a safe investment in the event of default by the management company, depository and/or promoter as their assets are separate from the entity responsible for managing them (Management Company) and the entity responsible for the custody of their securities (Depository) and its owners are the unit-holders, which are perfectly identified by the distributor.

In Europe, Money Market Funds have very important differentiating elements compared with deposits, such as:

Ownership. The investors in Money Market Funds are the owners.

Transparency. The investors in Money Market Funds have access to periodic information on the investments carried out through their investment.

Limits on investment and indebtedness. The investment policy of Money Market Funds restricts their investments to short-term assets with a high credit rating. Indebtedness is limited to 10% and must be temporary.

Diversification. A limit is placed on the percentage of securities issued or guaranteed by a single issuer in the Fund's total managed assets (generally, 5%) and the Fund may not exercise significant influence over the management of the issuer.

Repo operations are subject to the minimum capital requirements established by EU legislation and which result from the agreements of the Basel committee on banking supervision⁶.

Spanish regulation with regard to securitisation processes already requires the existence of a vehicle, with a management company in-between the originating bank and the investors with the obligation to protect the interests of investors⁷.

At the time of the issue, the management company presents a prospectus that must be verified by the securities supervisor (CNMV), which establishes the conditions of the issue. This prospectus includes all the relevant information on the assignor, the risks, the guarantees, the assigned assets and the possible foreseeable scenarios.

It is important to mention that the assignment of assets to the vehicle does not involve de-registering the assets from the balance sheet of the assignors. Therefore, the assignors are still required to record the assigned assets in their balance sheets and, consequently, have to comply with their capital requirements regulation⁸. In addition, it is noteworthy that assignors are required to file audited annual accounts as in most countries, but in Spain the management companies and the vehicles are also required to do so. Furthermore, the vehicles themselves (including securitisations aimed exclusively at qualified investors, known as private

⁶ Act 24/1988 of 4 July, Royal Decree 216/2008 of 15 February, Bank of Spain Circular 3/2008 and CNMV Circular 12/2008 of 30 December.

⁷ Royal Decree 926/1998 of 14 May

⁸ Bank of Spain Circulars 4/2004 and 3/2008.

securitisations) must file half-yearly reports prepared in accordance with specific regulations⁹ enacted by the CNMV. These reports include the balance sheet, income statement, the cash flow statement and a series of significant information about loan to value, average life, types of assets, performance of the assets and liabilities over the half-yearly period, collateral and counterparties. These reports are available to the public through the CNMV's website and allow comparison between the different securitisation bonds issued. The CNMV is ultimately responsible for supervising that the information has been prepared in accordance with prevailing accounting standards and prepares a half-yearly report for the sector as a whole.

In this regard, we believe it is important that the Spanish regulation of securitisation is taken as an example at an international level, since it has allowed the assigned assets to remain on the balance sheet of the assignors, own resources to be calculated correctly and a transparency regime well above that existing in other countries.

Therefore, it should be pointed out that in some countries, including Spain, the existing regulation seems appropriate to reduce the risks inherent in the shadow banking system.

3.The regulatory proposals of the FSB

As stated in its consultative document entitled “An integrated Overview of Policy Recommendations” the FSB is proposing regulation aimed at reducing systemic risks associated with five specific areas of shadow banking¹⁰:

- (i) to mitigate *the spill-over effect between the regular banking system and the shadow banking system*;
- (ii) to reduce the susceptibility of *money market funds (MMFs)* to “runs”;
- (iii) to assess and mitigate systemic risks posed by *other shadow banking entities*;
- (iv) to assess and align the incentives associated with *securitisation*; and
- (v) to dampen risks and pro-cyclical incentives associated with *secured financing contracts such as repos, and securities lending* that may exacerbate funding strains in times of “runs”.

The two particular consultations on which the FSB is seeking comments at this time and that will be discussed below are about issues (iii) and (v).

3.1.Comments on “A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities”

This document presents a set of policy tools that the FSB deems appropriate to reduce systemic risks posed by shadow banking entities other than MMFs, that is other investment funds (including hedge funds), broker-dealers, structured finance vehicles, finance companies and financial holding companies. Here we present the answers to the questions posed on this consultative document.

⁹ CNMV Circular 2/2009.

¹⁰ FSB: An Integrated Overview Of Policy Recommendations”, p.3.

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?

The proposed policy framework for other shadow banking entities consists of three elements:

- Identification of the economic functions that are performed by these entities and may pose systemic risks.
- Creation of a “policy toolkit” for each function, to provide a menu of choices from which authorities in each country may choose from.
- Recommendations on information-sharing among authorities about identification and policy tools being used in their jurisdictions. This is intended to maintain consistency and minimize “gaps” across jurisdictions in applying the policy framework, so as to reduce regulatory arbitrage opportunities.

Regarding the first point, the focus of the high-level policy on functions rather than institutions is well designed. Regulation by function is always more inclusive and efficient than regulation by entity, because once specific entities are regulated, financial innovation may create new entities to perform the same functions. Moreover the five functions that have been identified seem to comprise all the activities that are performed by financial institutions other than banks and may pose systemic risks because they may lead to runs.

The second and third points are more problematic. Proposing policy toolkits for each function as a menu and leaving its use to each country authorities can generate important regulatory differences. These differences can arise from differences in the quality of regulation across jurisdictions that may be opportunistically used by financial institutions to engage in regulatory arbitrage, but they may also arise from regulatory competition on a race to the bottom to attract global financial institutions. Given the importance of contagion risks in the global financial market leaving the door open to regulatory competition of this type may be dangerous. A more sensible approach would be to specify some minimum regulatory standards and allow the different jurisdictions to adopt stricter regulation if they wish to do so.

One of the things that we observe from the data is the different incidence of shadow banking across different jurisdictions with different regulations. This is especially true when we look at Europe and the EU in particular. All this seems to point to different regulations that make these functions stay within banks or get transferred to other entities. Therefore it would be interesting to study the differences in regulations and to identify the important differences that make shadow banking more prevalent in some countries. This would make it possible to identify which basic policies should be maintained across all jurisdictions and which ones should be optional.

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 five economic functions identified seem to capture all potential sources of systemic risk.

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.

One of the things that have become clear during the current financial crisis is the limited capacity of regulatory authorities, and central banks in particular, to keep up with innovations in the financial sector. It is difficult to argue with the idea that collecting more information is always good, but one must think about the relative benefits and costs of these information policies. To the extent that these information items are not linked to the policy instruments proposed, requiring more information may be overstretching regulatory authorities with limited resources.

With regard to this point, it seems interesting to promote the creation of trade repositories, as a channel to collect the large amounts of information needed on ongoing shadow banking activities.

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?

Banking crisis are started by liquidity shocks that make a large number of investors demand cash from their deposits. Some shocks may be exogenous, but many times the shocks are endogenous, and they are caused by an increase in the asymmetry of information about the quality of the bank's assets.

Because of this, if we want to avoid systemic risks there are four basic types of regulation that we can use:

1. Regulation restricting the liquidity of deposit-like instruments (e.g. redemption fees, suspension of convertibility, etc.).
2. Regulation restricting the use of deposit-like instruments to fund long-term investments (e.g. capital requirements, restrictions on the use of client assets and liquidity requirements such as the laddering of liabilities maturities, etc.).
3. Regulation reducing asymmetric information about the quality of the assets backing the deposits (e.g. extending explicit government insurance to non-bank financial institutions, restricting the types of investments that they can make, imposing coinsurance and deductibles on investors seeking credit default insurance and regulating the activities of the credit rating agencies (CRAs)).
4. Regulation for dealing with systemic crisis once they occur.

Most of the policy toolkits in the FSB's proposal fall within the first two types of regulation (restrictions on the liquidity or the use of deposit-like instruments). With respect to the third type of regulation the only proposal refers to the use of coinsurance and deductibles, because CRAs are not considered financial institutions. But there isn't any toolkit aimed at the resolution of crisis once they occur, restoring the solvency of the system quickly and without imposing externalities on third parties. The rest of the regulatory measures can reduce the probability of a crisis occurring but good resolution mechanisms can also reduce the costs of systemic crisis once they occur and reduce the probability of their occurrence by changing the incentives of the institutions to overleverage. These resolution mechanisms could include the use of contingent capital (as proposed by Bolton and Scheinkman 2011), the use of convertible debt to remunerate the managers of financial institutions (as explained by Bolton, Freixas and Shapiro 2010) and the design of special bankruptcy procedures for financial institutions that transform debt into equity by using options (as discussed by Bolton and Samama (2010)).

Analyzing the toolkits proposed for each economic function we reach the following conclusions.

Toolkits for management of client cash pools with features that make them susceptible to runs

Here the main problem relates to the MMFs offering an implicit guarantee through the use of constant net asset value. But this issue is left outside the scope of this consultative document.

Therefore the proposed policy toolkits are to be applied to other investment funds. These toolkits try to reduce the systemic risks caused by the operations of these funds in two different ways. The first is to restrict the liquidity of the funds through restrictions on redemptions. The second is to reduce asymmetric information by restricting the types of assets that these funds may hold and imposing limits on the maturity of the assets, limits on the concentration of the assets, limits to investments with no secondary markets and liquidity buffers.

The main problem is how to establish the correct limits for the assets. If these limits are too restrictive and make the pool of eligible assets is too small regulation may be counter-effective and increase the risk of runs on these funds, because overall the risks will concentrate on very few assets and, small changes in the values of one class of assets may have a large impact on the system. Moreover, high demand for one class of assets may lead to endogenous ratings inflation.

Finally it is important to note here that most of these limits already exists in Spain (Ley 35/2003 de IIC de 4 de noviembre, RD 1309/2005 de 4 de noviembre y circulares de la CNMV 1/2009 de 4 de febrero y 3/2011 de 9 de junio.).

Toolkits for loan provision that is dependent on short-term funding

Here we find the activities of non-bank institutions that are issuing deposit-like instruments to finance loans, which is the basic definition of a bank. These are clear cases of regulatory arbitrage and the obvious solution is to force these institutions to become banks or to consolidate into their parent bank's balance sheet. The proposed policy toolkits on capital requirements, liquidity buffers, leverage limits, etc. attempt to impose prudential banking

regulation on these institutions, in an indirect manner. But a direct one would be simpler and put them under the correct regulatory institution.

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

This function refers to the funding of broker-dealers through the use of deposit like instruments.

The problem appears because the regulator cannot make a credible commitment not to bail them out in the case of a crisis, and they benefit from this implicit insurance, that allows them to function with high levels of short-term leverage. Nevertheless, subjecting broker-dealers to prudential regulation and offering explicit state guarantees does not seem sensible, because, as pointed out in the document, they do not make long-term loans and are not central to the credit intermediation process in the economy. Restrictions on leverage and on re-hypothecation seem the most adequate.

Facilitation of credit creation

Credit creation is facilitated by financial insurers and financial guarantee companies. Just like in the previous case the problem arises because these institutions have been bailed out during the crisis and now they have an implicit government insurance that recommends the imposition of restrictions on leverage. However in this case there is an extra tool that may be used which is co-insurance. This is a very useful tool because it can help reduce asymmetric information about the quality of the assets being used as collateral in the securitisation processes and it can also reduce incentives to run.

Securitisation and funding of financial entities

In the case of securitization vehicles that are being used to bypass prudential banking regulation the solution is to put them back into its parent bank's banks balance sheets.

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.

3.2.Comments on “A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos”

In this document the FSB presents a series of recommendations intended to reduce the financial stability risks generated by the securities lending and repo markets. These risks are generated by the deposit-like qualities of these financial instruments, that makes them susceptible to runs and procyclicality. The recommendations refer to:

- (i) improvements in the transparency of these markets and the end users of the instruments.
- (ii) imposition of minimum haircuts
- (iii) restrictions on cash collateral reinvestment
- (iv) requirements on re-hypothecation
- (v) standards for collateral valuation and management
- (vi) structural changes in the clearing of these markets and to the favorable treatment of these instruments in case of bankruptcy.

In this document we find questions regarding the principles that should guide regulation and also more technical questions about the details of the regulation on haircuts and information processing. Here we present some brief answers to the questions on the main principles that should guide regulation.

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.

Yes the risks seem well identified. These risks are generated by the deposit-like qualities of securities lending and repo operations that are used to finance illiquid assets, thus generating the possibility of runs that can cause a systemic default of the financial system and can generate procyclicality in the credit markets.

Q2. Do the policy recommendations in the document adequately address the financial stability risk(s) identified? Are there alternative approaches to risk mitigation (including existing regulatory, industry, or other mitigants) that the FSB should consider to address such risks in the securities lending and repo markets? If so, please describe such mitigants and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?

One of the issues on which the document is silent is on the convenience of allowing non-bank entities to engage in repo. It takes for granted that they are engaged. But, if repo and securities lending were only performed by banks their regulation would be an issue only for banking regulation. And since other financial institutions are not subject to prudential banking regulation, financial stability risks could be reduced by preventing other financial intermediaries from offering repos.

Therefore it is important to carry out a cost-benefit analysis before concluding that other financial institutions should engage in repo and that repo should be regulated. Different authors have considered different reasons why repo takes place outside traditional banks and have different views on whether other financial institutions should be allowed to engage in

repo. On the one hand Gorton and Metrick (2010) argue that, although many investors use repos as a safe deposit-type account, there is also a demand for repo arising from investment, risk management and collateral management strategies, and this justifies allowing non-bank entities to engage in repo. On the other hand Perotti (2010) thinks that the only reason why other entities can compete with traditional banks in the repo market is because of the particular regulation of bankruptcy in some jurisdictions that confers repo a “safe harbour” status in bankruptcy and exempts these contracts from “automatic stay”. This allows other financial institutions to offer a guarantee on repos in case of default.

Interestingly Gorton and Metrick (2010) argue that minimum haircuts and position limits should be more restrictive for other non-bank entities. This way repo outside of banks is constrained and there is an advantage to being a bank and less reasons for regulatory arbitrage.

Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment?

Q4. Please address any costs and benefits, as well as unintended consequences from implementing the policy recommendations in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers, to the extent possible, that would assist the FSB in carrying out a subsequent quantitative impact assessment.

Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks)?

Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items.

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

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

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.

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.

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?

Q12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?

Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

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

Q15. In your view, how would the numerical haircut framework interact with model-based haircut practices? Also, how would the framework complement the minimum standards for haircut methodologies proposed in section 3.1.2?

Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

Q17. Are there specific transactions or instruments for which the application of the numerical haircut floor framework may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.

Q18. In your view, how should the framework be applied to transactions for which margins are set at the portfolio basis rather than an individual security basis?

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?

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

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?

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?

The theoretical argument for allowing repos and CDS to have a special status in bankruptcy is not well established. Moreover, taking into account that this may be the reason why repo has developed outside the traditional banking sector in some jurisdictions and not in others this issue deserves more attention. It may not be sensible to change these laws at the present time and cause disruption in these markets now that liquidity is a major concern. But we think it is important to open the debate about the convenience of the “safe harbor” status of repos and CDS in bankruptcy and to consider proposals such as the tax on bankruptcy privileges proposed by Perotti and Suárez (2009). As Perotti (2012) puts it “At a time when all lenders seek security, questioning the logic of safe harbour provisions may seem unwise. Yet at the system level, it is simply impossible to promise security and liquidity to all.”

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