German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on FSB Strengthening Oversight and Regulation of Shadow Banking - Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (Annex 2 Regulatory Framework for Haircuts)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Comments on FSB Strengthening Oversight and Regulation of Shadow Banking - Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

I. General remarks

Securities lending and repos are a key component of global financial flows. This is the case in both the non-banking and all the more so in the banking sector. Thus, securities lending and repos per se are not a part of the shadow banking sector. Whilst securities lending and repos are also used for financing in the non-banking sector, regulation should nevertheless not lose sight of the fact that the **banking sector will very much feel the impact of comprehensive regulation** and this in the inter-bank segment and also within banking groups. We are pleased that the FSB is aware of this issue. Therefore, regulation should heed and apply already existing legislation in the evaluation. Even if indirect regulation via banks cannot be avoided, the objective of the initiative should be honoured by looking for possibilities for **specific regulation of the shadow banking sector**.

Additional regulation cannot fail to have side effects. There is a risk that market participants will turn their backs on the market, thus **removing liquidity** from the market and hindering efficient pricing. Reduced liquidity is probable even without market exits however, in particular through interactions with other regulatory initiatives. This will have significant effects on the **refinancing** of the financial sector and ultimately also on the real economy, which would be faced with more expensive borrowing. Hence, a sense of proportion is called for so that future regulation is applied accurately. In this context, we would also like to draw attention to the additional burdens facing the repo segment with respect to the planned financial transactions tax[1].

The main argument of the presented paper is that the dynamic adjustment of haircuts exacerbates **procyclical effects**. However, it has **not been sufficiently proven** that haircuts do in fact significantly influence procyclicality and are thus the right regulatory approach. Other, market-driving lending terms can have similar procyclical effects in times of crisis as haircuts. It is therefore doubtful whether defining obligatory haircuts can in fact avoid procyclical effects. For the regulated banking sector, in this context, attention is drawn to other regulatory initiatives, in particular Basel III, since the key aim is to reduce both procyclicality and also the build-up of excessive leverage (anti-cyclical capital buffers, minimum standards for liquidity requirements, leverage ratio).

We welcome the fact that possible haircuts are to be adapted to the differing quality (volatility, liquidity). In our opinion, there are however other securities which require only smaller haircuts due to their quality (e.g. liquid Pfandbriefe).

The introduction of binding minimum haircuts will exacerbate the tendency to bottlenecks in the volume of eligible collateral also observed by the regulators. This would at the same time lead to increased asset encumbrance.

In addition, the introduction of obligatory minimum haircuts can in itself lead to a **race to the bottom.** Even if it is only meant as a supervisory floor, it nevertheless acts as an indication to individual market participants that convergence in this direction is not all that remote. Such a convergence itself leads in turn to the undesired procyclical effects. Therefore, minimum haircuts should be unmistakably structured as a backstop regime so as not to anticipate, yet alone stymie, market participants' risk judgments.

[1] see http://www.die-deutsche-kreditwirtschaft.de/uploads/media/130515-FTT-Dreiseiter_2.3_01.pdf

Haircuts depend largely on confidence in the market and in the counterparty and also the provided collateral. The asset value of the collateral and the creditworthiness of the counterparty form the basis for **individual and case-based risk decisions**. Counterparty credit risk has, in our opinion, not been given sufficient attention in the consultation document; minimum haircuts must be given enough leeway for adjusting haircuts appropriately to reflect the counterparty involved or the collateral provided. The regulatory approach adopted should accommodate this, so that banks are in a position to form risk-based haircuts using the actual specific risks and thus to act in an economically correct manner. The introduction of obligatory minimum haircuts leads to **schematisation** and standardisation, however. Market participants might well react to this by changing the other lending terms (changing maturity dates, credit lines). This would however work contrary to the intended effects of the standardisation. We therefore favour a backstop regime approach.

A less intrusive, but possibly effective alternative regulatory tool for avoiding undesired market behaviour could be the obligation to **draw up and document an internal methodology** for computing the haircuts and improving collateral valuation. The documentation obligation would give the supervisory agencies better recourse to the banks.

Since there is no market-wide definition, we would welcome an attempt to define securities financing transactions as broadly and uniformly as possible. Only then could the effects of the policy recommendations be discussed more accurately.
Consideration should be given to whether the introduction of a duty to draw up a methodology might not already suffice. In the case of "hard" regulation, it would be advisable to concentrate on volatile instruments that do in fact have pronounced cyclical fluctuations in order to be keep unwanted effects to a minimum. In so far as possible, regulation should directly focus on the addressees of the regulatory objectives. Should there nevertheless be indirect regulation via (already regulated) banks, this must avoid any indirect negative impact on the pure inter-bank market, since revitalisation of this market is at the same time a goal of the central banks, for example.

II. Specific remarks

Part 1 General questions

Q1. Do the proposed policy recommendations in Annex 2 adequately limit the build-up of excessive leverage and reduce procyclicality? Are there alternative approaches to risk mitigation that the FSB should consider to address such risks in the securities financing markets? If so, please describe such approaches and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?
Q2. What issues do you see affecting the effective implementation of the policy recommendations?
Q3. Please address any costs and benefits, as well as potential material unintended consequences arising from implementation of the policy recommendations? Please provide quantitative answers, to the extent possible that would assist the FSB in carrying out a quantitative impact assessment. [Note: respondents may also consider participating in QIS2]

Comments on FSB Strengthening Oversight and Regulation of Shadow Banking - Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

The policy recommendations ignore the fact that the repo market plays a central role in liquidity adjustments among commercial banks and thus, as a transmission mechanism for monetary policy actions, makes it that much easier for central banks to carry out their tasks. Whilst the exclusion of transactions with central banks due to their minimal risk is welcomed, this is not sufficient for solving monetary policy problems. Efficient and stable liquidity at banks is a further key prerequisite for supplying liquidity to all parts of the economy, be it business, the public and private sectors. At the short-end this is ensured in no small way by the repo/lending markets. Even if pure inter-bank business is excluded from the minimum haircuts, regulation would still affect this business, since both markets "trade" the same securities and hence separating them is not possible.

Repo transactions are also of course concluded with and within the non-banking sector. The share of the non-banking sector varies considerably from economy to economy, however. Shadow-bank business in Europe is far less important than in the United States and, according to the Bundesbank, is above all in Germany “small on a global comparison”. The estimated net assets of shadow-bank entities in Germany amount to approximately 15% of total assets of the regular banking sector compared with 110% in the USA. In addition, actors in the German shadow banking sector were currently “aware of only minor risks” (source: Deutsche Bundesbank, Finanzstabilitätsbericht 2012). Such a differentiated view has yet to be noticed in the regulatory approaches so far proposed.

Analysing the various repo markets more closely would also reveal their differing quality. Whereas the securities lending and repos segment in Europe is dominated by banks, broker-dealer entities, insurance companies and pension funds are much more important in the comparable US market for example. It may be noted that the lion's share of securities lending and repo transactions in Europe takes place in the inter-bank market – or in intra-group dealings – and thus in a strictly regulated arena. This means on the one hand that the risks remain on the collateral provider's balance sheet and there is no risk transfer. On the other hand, all the regulated banks in Europe have access to their central banks and thus have a lender of last resort, at least to a certain extent. Shadow banks, which unlike in Europe account for a major part of the market in the USA, do not have such access to liquidity. This also reduces the danger in certain important markets of uncontrolled interactions which the paper wishes to address.

In view of these structural, risk-relevant differences we would argue for differentiated regulation. The distinctions in the consultation document are a step in the right direction.

Any type of regulation can have undesired side effects. Inappropriate regulation of the repo and securities lending sector runs the risk that market participants will turn their backs on the market, thus **removing liquidity** from the market and hindering efficient pricing. This will have significant effects on the **refinancing** of the financial sector and ultimately also on the real economy, which would be faced with more expensive borrowing.

In addition, it has not been proven that haircuts have a procyclical effect. Other credit factors (changing maturity dates, credit lines) can also play a decisive role in a procyclical spiral. This aspect has been largely ignored so far. We also feel that insufficient attention has been given to the fact that the bank supervisory agency is already tackling procyclical tendencies though measures such capital buffers, liquidity requirements and the leverage ratio. In addition, the introduction of obligatory minimum haircuts can in itself lead to a **race to the bottom.**

Even if it is only meant as a supervisory floor, it nevertheless acts as an indication to individual market participants that convergence in this direction is not all that remote. Such a convergence in turn fosters the undesired procyclical effects.

The idea of introducing central clearing (CCP) here can also lead to the structure becoming more of a monopoly or oligopoly with the corresponding negative effects. Market participants could become dependent on a standardised CCP risk approach; the resulting unison could feed the procyclicality.

The introduction of binding minimum haircuts will exacerbate the tendency to bottlenecks in the volume of eligible collateral also observed by the regulators. This would at the same time lead to increased asset encumbrance.

Haircuts depend largely on confidence in the market and in the counterparty and also the provided collateral. These factors form the basis for **bank-specific and case-based risk decisions**. In the light of this, haircuts based on the particular bank, counterparty (counterparty credit risk) or the provided collateral could then vary significantly. The regulatory approach adopted should accommodate this, so that banks are in a position to form risk-based haircuts using the actual specific risks and thus to act in an economically correct manner. The introduction of obligatory minimum haircuts leads however to a **schematisation** and standardisation, with insufficient heed being given to the transaction-specific risk.

While the concern about low haircuts contributing to per-cyclicality is understood, specific minimum haircuts levels can turn out to be very rigid and inflexible, possibly leading to a distortion of the market in quiet market phases, whereas the minimum haircut levels may be far too low to show any effect in times of financial market stress.

It might be advantageous to develop the design of an appropriate framework for calculating haircuts rather than setting fixed minimum levels. The framework should include the factor "creditworthiness of the counterparty".
Instead of fixed floors a flexible alternative should be found, which relies on self-responsibility of the market participants (such as for example No. 46 ESMA Guidelines on ETFs).

In addition, it is advisable to ensure consistency between different regulatory systems, (e.g. with No. 46 ESMA Guidelines on ETFs). These guidelines focus on the personal responsibility of market participants in the following way:
"A UCITS should have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a UCITS should take 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 performed in accordance with paragraph 47. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets."

Q4. What is the appropriate phase-in period to implement the policy recommendations? Please explain for (i) minimum standards for methodologies and (ii) the proposed framework for numerical haircut floors separately.

A phase-in period of at least one year is probably reasonable both for implementing the methodology and also the floors for numerical haircuts. The implementation periods for other regulatory initiatives that impact market liquidity influence should also be taken into consideration (e.g. CCP-Clearing, Margining for non-cleared derivatives, LCR).

Part 2 Questions on the minimum standards

Q5. Are the minimum standards described in Section 2 appropriate to capture all important factors 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?

Even if the aim is to prevent procyclical effects in a (new) crisis, the proposal to extend the horizon so far that at least one stress period is covered calls for a critical assessment. For example, the inclusion of stress periods leads to higher haircuts, even if a recovery is long since underway. Countries in crisis, such as Greece, would always "be shouldering" the last stress period because of this "legacy". Implementing such a proposal would serve to prolong the crises. The proposals therefore contain considerable potential for hindering market recovery and financing for countries in crisis. A negative influence on central banks' monetary policy is also to be expected.

Another question that arises is how long these data are to be collected. The proposed approach would also entail having to hold onto data for several years, so that a previous stress period can be mapped. Concerning the "wrong-way risks", clarification is also required above all as to what extent the correlation between counterparty and collateral is to be taken into consideration. Far-reaching quantitative procedures, e.g. including potential non-performance correlations between counterparty and collateral issuer, would imply model risks and moreover involve the added burden of data management. In our opinion, including "wrong-way risk" for computing haircuts is therefore not suitable for market-oriented controls. A viable alternative is, in our opinion, regulation via a "collateral policy" subject to supervisory review. Under a "collateral policy" there is scope for a more differentiated and comprehensive risk evaluation than is possible by stipulating standardised haircuts.

Such a "collateral policy" should cover both the counterparty and the product risk. On the counterparty side, a restriction for certain counterparty groups both with respect to the size of the contracts (concentration risk) and also with respect to the link between counterparty and collateral (correlation risk, "wrong-way risk") could be effective. On the product side, factors such as type of collateral (shares etc.), creditworthiness (investment grade), maturities or currency group should be taken into consideration for evaluating collateral. For shares, eligible market segments (main indices) could be determined. In addition, there are other relevant factors that should be collected and integrated to define the details of this proposal. In our opinion, the introduction of such a "collateral policy" is especially suitable for avoiding the addressed procyclical effects. To provide incentives for these desired individual risk assessments, minimum haircuts should – as already mentioned – be designed as a backstop regime.

Q6. Would the additional considerations described in Section 3 appropriately capture all important factors that should be taken into account in setting risk-based haircuts on a portfolio basis? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?

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Part 3 Questions on floors for numerical haircuts

Q7. In your view, is there a practical need for further clarification with regard to the definition of proposed scope of application for numerical haircut floors?
Q8. Would the proposed scope of application for numerical haircut floors be effective in limiting the build-up of excessive leverage outside the banking system and reducing procyclicality of that leverage, while preserving liquid and well-functioning markets? Should the scope of application be expanded (for example, to include securities financing transactions backed by government securities), and if so why?
Q9. In your view, what would be the impact of introducing the numerical haircut floors only on securities financing transaction where regulated intermediaries extend credit to other entities? Does this create regulatory arbitrage opportunities? If so, please explain the possible regulatory arbitrage that may be created and their impact on market practices and activity.

Firstly, we greatly welcome the fact that the FSB proposal relates solely to transactions between banks and non-banks and trading among non-banks. This means that floors for numerical haircuts would be introduced for those business activities in which the feared contagion effects can arise. It is also welcomed that transactions with central banks would be excluded. However, it should not be overlooked that this exception alone will not prevent the impact of monetary policy measures being distorted.

It is also particularly welcome that collateral in the form of government securities is excluded from the numerical haircut floors. Such a restriction appears appropriate since these securities have very much lower haircut volatilities. A logical extension of the exceptions would be to include particularly crisis-proof instruments such as highly liquid Pfandbriefe with a high credit quality.

A uniform definition of SFTs would generally be welcomed. This would clearly stake out the scope of application.

Q10. In your view, would the proposed levels of numerical haircut floors as set out in table 1 be effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets? If not, please explain the levels of numerical haircut floors that you think are more appropriate and the underlying reasons.
Q11. Are there additional factors that should be considered in setting numerical haircut floors as set out in table 1? For example, should "investment grade" or other credit quality features be factored in?

Distinguishing by term and nature of instruments is in principle positive. We would consider further differentiation helpful, for example separate treatment of shares listed on the German MDAX, for example.

A separate category for Pfandbriefe, in so far as an exception is not possible, would be appropriate in our view. Pfandbriefe, unlike mortgage-backed securities (MBS), do not involve any risk transfer. From the risk perspective, we find it hard to grasp why for example a German Pfandbrief, one of the most secure investment instruments in the world, should be subjected to the same haircut as US mortgage-backed securities, for example.

Q12. Are there any practical difficulties in applying the numerical haircut floors at the portfolio level as described above? If so, please explain and suggest alternative approaches for applying the numerical haircut floors to portfolio-based haircut practices?

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Q13. What are your views on the merits and impacts of exempting cash-collateralised securities lending transactions from the proposed framework of numerical haircut floors if the lender of the securities reinvests the cash collateral into a separate reinvestment fund and/or account subject to regulations (or regulatory guidance) meeting the minimum standards? Do you see any practical difficulties in implementing this exemption? If so, what alternative approach to implementing the proposed exemption would you suggest?
Q14. Do you think cash-collateralised securities borrowing transactions where the cash is used by the securities lender to meet margin requirements at a CCP should also be exempted from the proposed framework of numerical haircut floors?

In principle, we welcome the exception. However, we do feel it would be better to subject all comparable transactions to comparable regulations. This raises the issue of a crystal clear distinction in order to avoid inconsistencies.

Q15. What are your views on the proposed treatment of collateral upgrade transactions described above? Please explain an alternative approach you think is more effective if any.
Q16. What are your views on exempting collateral upgrade transactions from the proposed framework of numerical haircut floors if securities lenders are unable to re-use collateral securities received against securities lending and therefore do not obtain financing against that collateral?

The exclusion of collateral upgrade transactions from the framework of floors for numerical haircuts is generally welcomed.

Q17. What do you view as the main potential benefits, the likely impact on market activities, and possible material unintended consequences on the liquidity and functioning of markets of introducing the proposed framework of numerical haircut floors on securities financing transactions as described above?
Q18. Would implementing the proposed numerical haircut floors through regulatory capital or minimum margin regimes for regulated intermediaries be effective in reducing procyclicality and in limiting the build-up of excessive leverage by entities not subject to capital or liquidity regulation?
Q19. Are there specific transactions or instruments for which the application of the proposed framework of numerical haircut floors may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.

We refer to our responses to Q1 to Q3.

Q20. What would be an appropriate phase-in period for implementing the proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions? Please explain for (i) minimum qualitative standards for methodologies and for (ii) numerical haircut floors separately.

The phase-in period should be consistent with the implementation of Basel III and the rules on bilateral margining for OTC derivatives.