



Secretariat of the Financial Stability Board
c/o Bank for International Securities
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28 November 2013

Re: FSB Consultation Document: Strengthening oversight and regulation of shadow banking, policy framework for addressing shadow banking risks in securities lending and repos – Annex 2: Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions

Dear Sirs and Madams,

The Global Financial Markets Association (“GFMA”)¹ and the Institute of International Finance (“IIF”)² appreciate the opportunity to comment on the consultation paper issued in August 2013 by the Financial Stability Board (“FSB”) entitled “*Annex 2: Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions*” (“Consultative Paper”).

¹ The Global Financial Markets Association brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit <http://www.GFMA.org>.

² The Institute of International Finance, Inc. (IIF) is a global association created in 1983 in response to the international debt crisis, but has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability. Today the IIF has more than 450 members headquartered in more than 70 countries. For more information, please visit www.iif.com.

The Consultative Paper proposes a framework (the “FSB Haircut Framework”) comprised of two elements:

- (i) minimum qualitative standards for methodologies used by all market participants to calculate haircuts (including additional guidance for methodologies used by market participants to calculate margins on a portfolio basis) – (“Minimum Qualitative Standards”); and
- (ii) numerical haircut floors that will apply to non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation (“Unregulated Entities”) receive financing from entities subject to regulation of capital and liquidity/maturity transformation (“Regulated Entities”) against collateral other than government securities – (“Numerical Haircut Floors”).

The objective of the FSB Haircut Framework is to limit the build-up of excessive leverage outside the banking system and to potentially reduce procyclicality of that leverage. Further, the Consultative Paper clarifies that the FSB Haircut Framework would apply to portfolio margining in addition to stand-alone securities financing transactions and proposes additional requirements to that effect.

GFMA and the IIF support the goals and the objectives of the FSB. However, as stated in GFMA’s letter dated 14 January 2013³, any regulation introduced with the aim of furthering these objectives needs to be carefully tailored so as to not undermine the securities lending and repo markets, prime brokerage and other securities financing transactions, which serve several crucial roles in the financial system⁴, as outlined in this response.

Further, we believe the FSB should take into account other regulatory initiatives that have been implemented or proposed at global and national level, which directly and indirectly regulate the securities financing market and limit systemic risk and leverage of

³ <http://www.gfma.org/Initiatives/Shadow-Banking/GFMA-Submits-Comments-to-the-FSB-on-the-Consultative-Documents-Regarding-Shadow-Banking-Risks-in-Securities-Lending-and-Repos/>

⁴ As stated in the FSB “*Consultative Document on Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*”, published 18 November 2012:

Securities lending and repo markets play crucial roles in supporting price discovery and secondary market liquidity for a variety of securities issued by both public and private agents. They are central to financial intermediaries’ abilities to make markets, and facilitate the implementation of various investment, risk management, and collateral management strategies. Repo markets are also instrumental in monetary refinancing operations in many jurisdictions.

Unregulated Entities. Such regulations include: Basel III, AIFMD, UCITS, mandatory central clearing and trading requirements (e.g. Dodd Frank Title VII, EMIR and MiFID/MiFIR) and the recently issued BCBS leverage ratio proposals. Given these existing regulatory initiatives, additional regulation aiming to limit excessive leverage outside the banking sector needs to be proportionate, non-duplicative and should not be overly burdensome on the regulated banking sector.

We do not agree that regulated entities should be subject to even further regulation in order to indirectly regulate the unregulated sector. Indirect regulation could result in overburdening the regulated sector and lead to unintended consequences (e.g. transactions could move away from the regulated market). However, if the FSB does recommend indirect regulation, we believe the proposed use of margin requirements is a better means of achieving the FSB's goals than the introduction of a further capital requirements framework on Regulated Entities.

In this response, we discuss the FSB's proposed Minimum Qualitative Standards and Numerical Haircut Floors. We also provide our views on the potential challenges in implementing the FSB Haircut Framework.

The term "*securities financing transaction*" is commonly used and understood to have a broad meaning (i.e. includes all types of securities loans, repos and margin lending). Section 4.3 of the Consultative Paper states that the FSB framework of numerical haircut floors is intended to apply to transactions where "*the primary motive is to provide financing to entities not subject to regulation of capital and liquidity/maturity transformation, rather than to borrow/lend specific securities*". For the avoidance of any doubt, for the purposes of this response, we define a securities financing transaction where the primary motive is to provide an entity with financing as a "Financing Transaction".

Our key recommendations are:

- **The scope of the Minimum Qualitative Standards for haircut methodologies should match the more narrow scope of the Numerical Haircut Floors.** The arguments provided in the Consultative Paper for limiting the scope of the Numerical Haircut Floors equally apply to the Minimum Qualitative Standards. Implementation of the haircut methodologies as currently proposed would cause significant practical difficulties and would disrupt the functioning of the securities financing markets as outlined below.

- **The types of transactions that should be considered Financing Transactions subject to the FSB Haircut Framework should be more clearly defined.** A clear definition will avoid ambiguity, inconsistent implementation across jurisdictions, and adverse impacts resulting from non-financing transactions being subject to the FSB Haircut Framework. At a minimum, if the FSB does not wish to clarify a definition, it should detail transactions that fall outside the scope of Financing Transactions. Extending the Minimum Qualitative Standards beyond Financing Transactions could constrain the ability of banks and broker-dealers to borrow specific securities as required to ensure the efficient functioning of financial markets (e.g. to meet a delivery obligation, customer demand, segregation requirement, etc).
- **The FSB Haircut Framework should recognise cross-product and portfolio-based margining (i) between Financing Transactions covered by the FSB Haircut Framework and (ii) between Financing Transactions covered by the FSB Haircut Framework and other financial products outside of the FSB Haircut Framework.** If the cross-margined transactions are risk reducing and the arrangement is legally enforceable, a requirement within the FSB Haircut Framework to collect margin under each transaction separately would not be appropriate.
- **Non-centrally cleared derivative transactions that are cross-margined with Financing Transactions covered by the FSB Framework should be subject to the FSB Haircut Framework, rather than the BCBS-IOSCO framework.** Non-centrally cleared derivatives transactions and Financing Transactions often have very similar risk characteristics and provide market participants similar exposures. Non-centrally cleared derivatives transactions will become subject to a new and separate margin regime under the BCBS-IOSCO framework. In order to maintain existing cross-margining practices between derivatives and Financing Transactions covered by the FSB Haircut Framework, we propose that non-centrally cleared derivatives transactions, to the extent they are cross-margined with Financing Transactions, should be excluded from the BCBS-IOSCO framework and instead become subject to the FSB Haircut Framework. Alternatively, if it is not feasible for the FSB to introduce swaps into its Haircut Framework, the FSB should permit haircuts for Financing Transactions covered by the FSB Haircut Framework to be calculated on a cross-margin basis (i.e. cross margining across different assets).
- **The implementation of the FSB Haircut Framework should start no earlier than 2019.** The timeline for the implementation of the FSB Haircut Framework should be consistent with those of other regulations that impact the securities financing markets (e.g. BCBS-IOSCO margin requirements for uncleared derivatives and Basel III capital

and liquidity requirements). Further, the FSB August 2013 report⁵ (“FSB Report”) recommends, as a matter of urgency, for national regulators to collect more data on the secured financing markets. We do not believe that the FSB Haircut Framework should be implemented before regulators have had the opportunity to review more comprehensive data.

The continuing engagement of the FSB with market participants on issues related to a framework for haircuts for non-centrally cleared securities financing transactions is greatly appreciated. We would be pleased to meet with you to further discuss any of the matters referred to in this letter. Please contact GFMA and IIF by email should you require further information: Sidika Ulker (sidika.ulker@afme.eu), Robert Toomey (rtoomey@sifma.org) and Andres Portilla (aportilla@iif.com).

⁵ “Strengthening oversight and regulation of shadow banking, policy framework for addressing shadow banking risks in securities lending and repos”, 29 August 2013, http://www.financialstabilityboard.org/publications/r_130829b.pdf

Section 1: Minimum Qualitative Standards for methodologies used by market participants to calculate haircuts

Generally, GFMA and the IIF agree with the proposed Minimum Qualitative Standards parameters. The list proposed by the FSB is comprehensive and includes factors that firms routinely use in their risk based capital calculations. We agree that haircuts should be based on long-term risks of the assets and be calibrated at a high confidence level. However, the proposed FSB Haircut Framework focuses solely on the value of the collateral taken and may not be sufficiently flexible to allow appropriate risk management by Regulated Entities. In order to be able to manage the amount of leverage provided to Unregulated Entities, Regulated Entities need to be able to take into account the risk profile of counterparties and other context dependent factors (e.g. cumulative risk exposure to a particular counterparty). These factors cannot be captured by regressing time series but are an important part of any proactive risk management. As these factors mitigate risk, the FSB Haircut Framework should permit these factors, as appropriate, to be included in a firms' methodology or should enable firms to adjust the haircut from the level that would otherwise be produced by the Minimum Qualitative Standards.

Scope of the Minimum Qualitative Standards for margin methodologies

The scope of the Minimum Qualitative Standards for haircut methodologies should match the more narrow scope of the Numerical Haircut Floors.

There is nothing inherent to the policy objective of FSB that would require the scope of Minimum Qualitative Standards to differ from that for FSB Numerical Haircut Floors; we recommend that the Numerical Haircut Floors exclusions should also apply to the Minimum Qualitative Standards.

In order to achieve the FSB's objective of limiting excessive leverage outside the banking sector, Minimum Qualitative Standards should, like the proposed Numerical Haircut Floors, be limited to transactions in which Unregulated Entities receive financing from Regulated Entities. Extending the Minimum Qualitative Standards beyond Financing Transactions (subject to general exemptions) could constrain the ability of banks and broker-dealers to borrow specific securities as required to ensure the efficient functioning of financial markets (e.g. to meet a delivery obligation, customer demand, segregation requirement, etc). We recommend that the FSB not only clarify that the Minimum Qualitative Standards apply only to Financing Transactions where the borrower is an Unregulated Entity but also clarify the definition of Financing Transactions or, at a minimum, detail transactions that are not considered Financing Transactions and are therefore exempted from the FSB

Haircut Framework (Section 2 of this response explains GFMA's and IIF's recommendations in this regard).

Further, the Minimum Qualitative Standards should not apply to the following transactions, which would be out of scope for the Numerical Haircut Floors:

- (i) transactions where the receiver of cash is a Regulated Entity;
- (ii) transactions collateralised by high quality government securities;
- (iii) transactions where the receiver of cash is a central bank; and
- (iv) centrally cleared transactions.

All these types of transactions are already subject to considerable regulatory scrutiny and/or do not contribute to excessive leverage and procyclicality outside the regulated banking system. Subjecting such transactions to Minimum Qualitative Standards would, in effect, result in minimum haircut levels. We believe this would have unintended consequences, including potential disruption to the functioning of global financial markets (e.g. the sovereign debt markets) and the transmission of monetary policy, as well as disincentivising the use of CCPs, contrary to existing policy objectives.

Furthermore, the arguments for excluding these transactions from the Numerical Haircut Floors (a number of which are outlined in the FSB's proposal) are equally relevant for the Minimum Qualitative Standards.

- Financing Transactions where the receiver of cash is a Regulated Entity should be scoped out because these FSB standards are concerned with excess leverage and procyclicality outside the banking system. Inclusion of such transactions is not relevant to furthering the objectives of the FSB in the context of shadow banking and would be duplicative and overly burdensome for the regulated banking sector.
- Transactions collateralised by high quality government securities should be exempted from the Minimum Qualitative Standards. Such transactions are critical to central bank operations and interest rate policy implementation. Given their low risk, high quality government securities often trade at low or zero haircuts. As noted in Section 4.3 of the Consultative Paper, price movements in government securities tend not to be procyclical and haircuts on these transactions have been comparatively stable over time. The FSB acknowledges that imposing Numerical Haircut Floors on these transactions could have a significant negative impact on the liquidity and functioning of core funding markets. The FSB's arguments apply equally in the context of the Minimum Qualitative Standards. Also, the Minimum Qualitative Standards should not, in effect, act as a haircut floor. GFMA and IIF would welcome further dialogue with the FSB and national regulators on factors that could be used to determine whether a government security is high quality.

- Securities financing transactions with central banks play an important role in the transmission of monetary policy. Subjecting such transactions to the FSB Haircut Framework could harm the ability of central banks to perform this essential function. Further, central banks do not pose financial stability risks. Therefore, transactions where the receiver of cash is a central bank should be out of scope.
- Centrally cleared transactions do not pose risks to financial stability or contribute to excessive leverage outside the banking sector. The purpose of the central counterparty clearing house is to reduce counterparty risk by acting as a central counterparty to trades and collecting margin requirements. Central counterparties do not provide financing. Inclusion of centrally cleared transactions in the scope of Minimum Qualitative Standards for haircut methodologies would disincentivise central clearing, contradicting other existing policy objectives.

Implementation of the Minimum Qualitative Standards

As proposed by the FSB in the context of haircut floors, firms should be able to manage risks through both haircuts and capital. Under the proposed FSB Haircut Framework for Numerical Haircut Floors, the FSB provides that if a firm sets a haircut at a lower level than the FSB floor, it will need to hold additional capital on its balance sheet. Generally, we agree that firms should be able to elect whether to manage its risks through charging haircuts or by holding more capital. However, the FSB Haircut Framework is silent on the relationship between the Minimum Qualitative Standards for calculation of haircuts and capital. Even though the proposed parameters for calculating haircuts are qualitative, they will have quantitative ramifications (e.g. 95% confidence interval over one stress period). However, under the FSB Haircut Framework, the implications for a firm setting a haircut lower than the level resulting from the Minimum Qualitative Standards is unclear. We recommend firms should be given the flexibility to enter into transactions with a haircut level lower than the amount calculated based on the parameters within the Minimum Qualitative Standards and instead hold capital against this risk in accordance with appropriate regulatory capital requirements. We do not believe the Minimum Qualitative Standards should, in effect, create a second, hard, haircut floor or supplant existing regulatory capital requirements.

Additional guidance for methodologies used by market participants to calculate margins on a portfolio basis

GFMA and IIF generally agree with the specific additional criteria proposed by the FSB – such factors are taken into consideration by Regulated Entities as a matter of general practice. However, the following points need further consideration:

- (i) risks offsets and hedging within cross-product and portfolio-based margining; and
- (ii) cross-margining of non-centrally cleared derivatives and Financing Transactions.

Risk offsets and hedging within cross-product and portfolio-based margining

The FSB Haircut Framework should recognise cross-product and portfolio-based margining (i) between Financing Transactions covered by the FSB Haircut Framework and (ii) between Financing Transactions covered by the FSB Haircut Framework and other financial products.

We believe the FSB Haircut Framework should recognise risk reductions and offsets arising from hedging between offsetting positions or correlated long and short exposures and diversification across the portfolio.

In particular, the FSB should endorse portfolio margining practices that allow the recognition of risk reductions and risk offsets: (i) across a broad range of assets classes within the same type of Financing Transactions (e.g. within a prime brokerage account: counterparty holds long and short positions which hedge each other at portfolio level); (ii) between different types of securities financing transactions (e.g. repo vs. prime brokerage: counterparty holds long bonds in a prime brokerage account that are hedge with short bond positions on repo); and (iii) between securities financing transactions and other financial products not covered by the FSB Haircut Framework, including uncleared derivatives, cleared derivatives and listed derivatives (e.g. prime brokerage account that are hedge with equity/index/bond futures/options in listed derivatives). The permissibility of these arrangements should, of course, be premised on their legal enforceability and the risk correlation of the cross-margined transaction.

Cross-margining of non-centrally cleared derivatives and Financing Transactions

Non-centrally cleared derivative transactions that are cross-margined with Financing Transactions should be subject to the FSB Haircut Framework, rather than the BCBS-IOSCO framework.

Non-centrally cleared derivatives transactions and Financing Transactions often have very similar risk characteristics and provide market participants similar market exposures (for instance, a margin loan on an equity security vs. a total return swap on the same equity security). Accordingly, today many firms provide portfolio-based margin across risk offsetting or risk reducing non-centrally cleared derivatives and Financing Transactions (particularly in prime brokerage).

Non-centrally cleared derivatives transactions will become subject to a new and separate margin regime under the BCBS-IOSCO framework. In order to continue the existing cross-margining practices between derivatives and Financing Transactions covered by the FSB Haircut Framework, we propose that non-centrally cleared derivatives transactions – to the extent they are cross-margined with Financing Transactions covered by the FSB Haircut Framework – are excluded from the BCBS-IOSCO framework and instead become subject to the FSB Haircut Framework. Alternatively, if it is not feasible to introduce swaps into the FSB Haircut Framework, the FSB should permit haircuts for securities financing transactions to be calculated on a cross-margin basis.

Non-centrally cleared derivatives transactions between the same parties that are not cross-margined with Financing Transactions covered by the FSB Haircut Framework would continue to be subject to the margin rules under the BCBS-IOSCO framework.

Section 2: Numerical Haircut Floors

The Consultative Paper proposes a framework for Numerical Haircut Floors with the aim of reducing procyclicality and limiting leverage outside the banking system. As GFMA provided in its January 2013 response, GFMA and IIF generally believe that Numerical Haircut Floors would be counterproductive. Regulatory floors on haircuts would decrease the flexibility of market participants to provide credit at a level that is appropriate to the transaction in the context of the counterpart relationship and thus would tend to distort markets. However, if numerical floors are to be introduced, we agree with the approach taken by the FSB: a simple framework with true backstop haircut levels. We stress that a numerical haircut floor framework needs to be comprised of levels that are in fact backstops and are not intended to be representative of market levels; if the levels are higher and aim to benchmark market haircut levels, we believe that this will cause serious market disruptions and reduce liquidity in the affected asset classes. Also trying to replicate market levels will bring to the fore the issue that simple haircuts do not reflect the risk in a portfolio and provide no incentive for market participants to hedge, diversify, or manage the liquidity of their portfolio.

Our comments relating to the specific details of the Numerical Haircut Floors are outlined below.

Scope of the Numerical Haircut Floors

GFMA and IIF generally agree with the scope of the Numerical Haircut Floors proposed by the FSB. As mentioned above we specifically agree with the exclusion of transactions collateralised with high quality government securities, transactions in which a Regulated Entity receives financing, transactions whereby a Regulated Entity provides an Unregulated Entity with cash or securities for a purpose other than for financing, transactions with central banks; and centrally cleared transactions.

Nonetheless, a number of elements of the proposed scope are unclear and could be interpreted in a number of different ways by national regulators and market participants. Therefore, the FSB Haircut Framework needs further clarification on:

- (i) the definition/scope of a Financing Transaction;
- (ii) the definition of high quality government securities; and
- (iii) the definition of a Regulated Entity

(i) Definition/scope of a Financing Transaction

The FSB provides that the numerical haircut floors are only intended to apply to transactions where *“the primary motive is to provide financing to entities not subject to*

regulation of capital and liquidity/maturity transformation, rather than to borrow/lend specific securities". To avoid ambiguity and inconsistent implementation across jurisdictions and prevent detrimental impacts resulting from non-financing transactions being subject to the rules, the FSB needs to clarify what should be considered a Financing Transaction. At a minimum, if the FSB does not wish to clarify the definition a Financing Transaction, it should detail transactions that fall outside the scope of Financing Transactions and are therefore exempted from the FSB Haircut Framework.

Where a Regulated Entity must determine whether the transaction is a Financing Transaction depending on its clients use of the cash/securities received (e.g. if the lender of the securities reinvests the cash into a separate reinvestment fund and/or account subject to regulations or agrees not to rehypothecate securities), the FSB Haircut Framework should permit Regulated Entities to rely on the representations and warranties provided by Unregulated Entities. In practice, it is impossible for a firm to otherwise know the intentions of its clients or to monitor the use of the cash/securities.

Margin loans: A margin loan involves the transfer of cash from the lender to the borrower and a pledge by the borrower of securities of equal or greater market value as collateral to the lender. In addition, the loan must be booked and documented as a margin loan. The pledged securities are custodied at the lender or at a third party custodian subject to a security interest in favour of the lender. The lender may have the right to rehypothecate some or all of the securities.

Recommendation: If the borrower uses the cash for the purpose of purchasing or maintaining securities positions, the transaction should be in scope of the FSB Haircut Framework, unless one of the general exemptions applies (i.e. the borrower is a Regulated Entity or central bank or the securities collateralising the loan are high quality government securities).

Excluding loans collateralised by securities where the proceeds are not used to purchase securities or maintain securities positions would be consistent with the objectives of the FSB. Such transactions do not increase leverage in financial markets and do not contribute to procyclicality because the loan is used for general non-financing purposes –a corporate borrower may use its loan proceeds to finance its operations. We note that in the United States ("US"), to our knowledge the only jurisdiction with margin rules of the type proposed in the FSB Haircut Framework, these types of margin loans are excluded under applicable regulation⁶.

⁶ See the definitions of "purpose credit" under Regulations T, U and X of the Board of Governors of the Federal Reserve System.

Repo/reverse repo transaction (including triparty repo): Under a repo, the buyer transfers cash to the seller and the seller transfers securities of equal or greater market value to the buyer.

Recommendation: The transaction should be considered to be in scope of the FSB Haircut Framework, unless one of the general exemptions applies (i.e. the borrower is a Regulated Entity or central bank or the securities collateralising the loan are high quality government securities).

Securities loan collateralised by cash: Under a cash-collateralised securities loan, the lender transfers securities to the borrower, and the borrower pledges or transfers cash, customarily in an amount greater than the market value of the securities, as collateral to the lender.

Recommendation: The transaction should be considered in scope of the FSB Haircut Framework, unless:

- (i) the lender of the securities reinvests the cash collateral in accordance with the minimum standards proposed under Section 3.1 of the FSB Report;
- (ii) the borrower intends to use the received securities to meet a current or anticipated demand (delivery obligation, customer demand, meet segregation requirement etc.); or
- (iii) one of the general exemptions applies (i.e. the borrower is a Regulated Entity or central bank or the securities collateralising the loan are high quality government securities).

Only a small portion of securities loans are used for financing. We agree with the Consultative Paper that a securities loan should not be considered a Financing Transaction if the lender of the securities reinvests the cash collateral pursuant to the standards of Section 3.1 of the FSB Report. However, solely taking the use of the cash collateral by the lender into consideration is not sufficient. The intended use of the securities by the borrower (i.e. the Regulated Entity) is also significant. If the transaction is driven by the current or anticipated demand of the borrower for the specific securities (e.g. to meet a delivery obligation, customer demand, segregation requirement etc.), the transaction is not a Financing Transaction— regardless of how the lender uses the cash collateral. Such transactions are critical to the smooth functioning of financial markets as outlined below. Applying haircuts to these loans could cause lenders to exit the market, potentially resulting in significant disruptions to global financial markets.

Looking to the purpose of the securities loan for the borrower (as opposed to the use of the cash by the securities lender) to determine whether a stock loan should be characterised as a financing transaction or not, is also consistent with current margin rules for broker-

dealers in the US (Regulation T of the Board of Governors of the Federal Reserve System). Under those rules, a US registered broker-dealer may generally engage in securities borrow transactions solely for a permitted purpose (for instance, for the purpose of making delivery of the securities). This is intended to prevent the parties from circumventing the margin rules and its minimum haircuts by simply documenting a transaction with the economics of a margin loan as a securities loan.

Securities lending plays an essential role in the efficient operation of the financial markets, providing a critical element of market liquidity. Amongst other things, securities lending, whereby the transaction is driven by demand for specific securities, provides the following benefits:

- allows broker-dealers to satisfy their securities delivery obligations in accordance with regulatory requirements;
- facilitates short selling in both equity and fixed income instruments, which contributes to market liquidity and price discovery and enables market makers, particularly in options and futures markets, to hedge their exposures, which generally helps keep spreads narrow and consequently minimises transaction costs for investors; and
- provides an opportunity for the beneficial owner of the securities (including pension funds and mutual funds) to earn additional income from securities positions. In order to enhance the return on their portfolios, with minimal additional risk.

Securities loans collateralised by securities

Scenario 1 – market value of higher quality securities is *lower* than market value of lower quality securities (“Borrow/Pledge”, “Collateral Upgrade”)

The lender transfers higher quality securities to the borrower and the borrower pledges or transfers lower quality securities of a market value greater than the market value of the higher quality securities as collateral to the lender⁷. The FSB provides that collateral upgrade transactions could be used to circumvent Numerical Haircut Floors by structuring a financing repo as a combination of a collateral upgrade transaction and a repo. We interpret the Consultative Paper to mean that the haircut floors for collateral upgrade transactions should be calculated by looking up the Numerical Haircut Floors that would be applied to the two assets involved in the collateral upgrade transaction and then taking the difference. We understand that the FSB does not intend for a separate repo transaction to

⁷ Note that the same economics of this transaction can be achieved (and accordingly the transaction should be treated in an analogous fashion), if the parties make the identical deliveries but switch roles –that is, the lender becomes the borrower and transfers the higher quality securities *as collateral* (rather than lending them), and the borrower becomes the lender and *lends* the lower quality securities of a market value greater than the market value of the higher quality securities (rather than transferring them as collateral)

be linked to the collateral upgrade transaction in the calculation of a floor. It would be helpful if the FSB could confirm our interpretation.

Recommendation: The transaction should be considered in scope of the FSB Haircut Framework, unless: (i) the borrower of the higher quality securities has agreed not re-use or rehypothecate the higher quality securities; (ii) the lender uses the lower quality securities received as collateral to meet a current or anticipated demand (delivery obligation, customer demand, meet segregation requirement etc.); or (iii) one of the general exemptions applies (i.e. the borrower of the higher is a Regulated Entity or central bank or the securities collateralising the loan are high quality government securities).

Scenario 2 - market value of *higher quality* securities is higher than market value of lower quality securities

The lender transfers *lower quality* securities to the borrower and the borrower pledges or transfers higher quality securities of a market value greater than the market value of the lower quality securities as collateral to the lender.⁸

Recommendation: The transaction should be considered in scope of the FSB Haircut Framework, unless: (i) the lender has agreed not to re-use or rehypothecate the higher quality securities received as collateral; (ii) the borrower uses the lower quality securities received as collateral to meet a current or anticipated demand (delivery obligation, customer demand, meet segregation requirement etc.); or (iii) one of the general exemptions applies (i.e. the lender receiving the higher quality securities as collateral is a Regulated Entity or central bank or the securities lent are high quality government securities).

As with cash collateralised securities loans, the intended use of the securities by the borrower or lender is a significant factor in determining whether the transaction is a Financing Transaction. If the loan is driven by the demand of the borrower or lender for the specific securities, the transaction should not be considered a Financing Transaction. A collateral upgrade transaction, where the transaction is driven by the demand of the lender or borrower for specific securities, provides real and material benefits to the economy; these include:

- they provide an alternative source of liquidity that enables banks to lower their liquidity risks;

⁸ Note that same economics of this transaction can be achieved (and accordingly the transaction should be treated in an analogous fashion), if the parties make the identical deliveries but switch roles – that is, the lender becomes the borrower and transfers the lower quality securities *as collateral* (rather than lending them), and the borrower becomes the lender and *lends* the higher quality securities of a market value greater than the market value of the lower quality securities (rather than transferring them as collateral).

- they provide an alternative means to utilise excess liquidity; and
- they allow market participants to obtain high quality liquid assets to use as collateral (including in the context of central clearing).

Since the peak of the crisis, there have been significant regulatory changes aimed at reducing systemic risk and increasing financial stability. Amendments to the Capital Requirements Directive (“CRDIV”), through the Liquidity Coverage Ratio, will introduce European-wide liquidity requirements to ensure banks have adequate liquidity buffer to withstand short term market disruptions. Similarly, OTC derivatives reforms, mandated by the G20, focus on reducing systemic counterparty risk through central clearing requirements. Such regulations are contributing to a significant increase in demand for high quality liquid assets.

Conversely, investors such as insurance companies, due to the nature of their businesses, may want to hold longer-dated, higher yielding assets in their portfolios. They may not want to solely hold liquid, lower yielding assets, such as gilts. To the extent investors own short term, liquid, lower yielding assets, these could be used to provide banks with liquidity or high quality collateral to meet regulatory demands.

It is essential that such transactions are not adversely impacted as a result of the FSB Haircut Framework.

Finally, we interpret table 1 of the Consultative Paper in relation to the Numerical Haircut Floors to mean that a borrow/pledge of two identical securities would fall outside of the scope of the collateral upgrade regime (the difference in the haircut floors would be zero). We agree with this approach because the risk of one security would be offset by the other, meaning a haircut would not be necessary. It would be helpful if the FSB could clarify this.

Short positions: A customer establishes a short position in its brokerage account if it sells securities it does not own. The customer pledges or transfers the short sale proceeds plus additional cash or securities as collateral to the broker. The broker has the right to use the short sale proceeds for any purpose. The broker may further have the right to use or rehypothecate some or all of the additional cash or securities collateral.

Recommendation: This transaction should be out of scope of the FSB Haircut Framework because neither party receives any financing.

(ii) The definition of high quality government securities

As stated above, we agree with the FSB approach to exclude government securities. However, we recommend that only high quality government securities should be excluded

from the FSB Haircut Framework (i.e. both the Minimum Qualitative Standards and the Numerical Haircut Floors). Low quality government securities are not liquid and are inherently more procyclical than high quality government securities; therefore, it is appropriate for low quality government securities to fall within regulatory risk management regimes. As indicated above, GFMA and IIF would welcome further dialogue with the FSB and national regulators on factors that could be used to determine whether a government security is high quality.

Further, we note that the Consultative Paper does not provide a definition of government securities. Although the FSB QIS2⁹ includes some guidance, it does not provide sufficient clarity. Whilst government bonds issued by government treasury departments clearly fall within the definition of government securities, it is unclear how other types of securities such as quasi-governments will be treated. Quasi-government securities include: US agency guaranteed bonds (Fannie Mae, Freddie Mac and Sallie Mae guaranteed bonds), European agency bonds (e.g. KfW and CADES bonds) and supranational bonds (e.g. EIB, ESFS and ESM bonds). We recommend that the FSB's Haircut Framework should not apply to high quality quasi-government securities.

(iii) The definition of a Regulated Entities

It is unclear how this element of the scope would work in practice; therefore, GFMA and IIF urge the FSB to provide further clarification.

As a result of national (e.g. Rule 15c3-1 promulgated under the U.S. Securities Exchange Act of 1934) regional (e.g. CRD IV) and global legislation (e.g. broker-dealers, swap dealers, FCM's and their parent companies are subject to capital and liquidity requirements under Basel), we read and interpret the FSB wording to treat such entities as Regulated Entities (e.g. thereby excluding interdealer transactions). However, express clarification of this by the FSB would be helpful.

Further, it is likely that other types of entities will be considered Regulated Entities. We urge the FSB to clarify that any such entity that demonstrates to its national regulator that it is subject to regulation with respect to liquidity and capital will be considered a Regulated Entity. GFMA and IIF *generally* interpret the scope as follows: insurance companies would generally be considered to be regulated entities (e.g. in Europe, due to Solvency I and II requirements); hedge funds would be unregulated entities; and pension funds would be unregulated entities.

⁹ "Proposed regulatory framework for haircut on securities financing transactions: instructions for the quantitative impact study (QIS2) for regulated financial intermediaries (banks and broker-dealers), Financial Stability Board (FSB), 5 November 2013, http://www.financialstabilityboard.org/publications/r_131105a.pdf

Details of the Numerical Haircut Floors

Generally, GFMA and IIF agree with the simple approach proposed by the FSB. We also believe that the Numerical Haircut Floor levels are generally appropriate backstops. Once again, we highlight that a Numerical Haircut Floor framework will only work if the levels are indeed true backstops. Any increase in the levels could dictate market levels, causing a race to the bottom and disincentivise firms from maintaining appropriate risk assessment systems and procedures. Also, we believe it could cause serious market disruptions and reduce liquidity in the affected asset classes.

A framework with haircut levels that intend to represent minimum market levels could not be simple; it would need to be highly granular and overly complex. For example, elements such as credit risk of the instrument and of the counterparty are not parameters of the framework. These are essential factors in the calculation of a haircut. A more sophisticated and granular table including credit risk factors (amongst other factors) would need to be included in a framework with increased levels. A simple numerical haircut floor table intending to dictate market levels would create severe distortions in the markets.

It would be helpful if the FSB could provide further clarification on the definitions of the collateral types included in table 1. For example, it is unclear what types of securities would be included in “other assets” and what would be included in the definition of debt securities (e.g. whether convertible bonds included).

Finally, the collateral type categories include a reference to maturity. We understand maturity in this context to mean the term of the security and not the life of the trade. It would be helpful if the FSB could clarify this.

Treatment of portfolio margining under table 1

The FSB recommends that for portfolio margining, the haircut levels should be no lower than the weighted average haircut floors that would be applied individually to the financing positions in the portfolio that are within the scope of the framework. This means that risk reduction through portfolio margining would not achieve a lower haircut level than individual transactions. Therefore, the FSB does not take into account risk reductions and offsets from hedging and diversification of a portfolio.

As discussed above, we believe that the FSB should recognise cross-product and portfolio-based margining (i) between Financing Transactions subject to the FSB Haircut Framework and (ii) between Financing Transactions subject to the FSB Haircut Framework and other financial products outside the FSB Haircut Framework. If the cross-margined transactions are risk reducing and the arrangement is legally enforceable, the Numerical Haircut Floor framework should give a benefit (i.e. a reduction in the floor). Currently, there is no such

recognition or benefit within the FSB Haircut Framework, disincentivising such risk management practices.

The FSB could introduce a regime for risk reduction through either:

- (i) margin relief or a scaling factor applied to numerical floors based on risk profile of the portfolio (e.g. net to gross ratio (NGR) used under the Basel capital framework, which references the ratio of the net current replacement cost to the gross current replacement cost, could be applied to the gross margin requirement to provide margin relief based on the hedged nature of the portfolio); or
- (ii) rules based margin relief could be provided on recognised hedging strategies (e.g. ADRs vs ordinary shares, convertible bonds vs short equities, warrants vs short equities)

GFMA and IIF would welcome further dialogue with the FSB and national regulators on incorporating cross-product and portfolio-based margining into the FSB Haircut Framework.

Implementation and enforcement of the Numerical Haircut Floors

In principle, we do not agree with additional regulation of entities already subject to BCBS standards-based prudential regulation for the purposes of indirectly regulating Unregulated Entities. We have concerns about adding to the regulatory burden of entities subject to both capital and liquidity regulation, in order to address threats to financial stability from Unregulated Entities. The impact of indirect regulation through regulated entities might be broader than intended given the breadth of activities performed by regulated entities and might lead to unintended consequences, including the movement of securities financing transactions outside the regulated sector.

However, if the FSB still decides to introduce its framework of Numerical Haircut Floors through additional regulation of Regulated Entities, then we believe that the use of margin requirements, rather than additional capital requirements, is the better policy choice. Margin requirements can be more adequately tailored to specific types of transactions. We would like to re-emphasise the importance of ensuring that Numerical Haircut Floors are implemented and maintained at backstop levels to avoid securities financing activities moving outside the regulated banking sector.

Thank you again for the opportunity to provide views on the Consultative Paper. We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis.

Yours sincerely,

A handwritten signature in black ink, appearing to read "David Strongin". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

David Strongin
Executive Director, GFMA

A handwritten signature in black ink, appearing to read "Andres Portilla". The signature is cursive and somewhat compact, with a large initial "A" and "P".

Andres Portilla
Director, Regulatory Affairs, IIF

cc. David Rule, Chair of FSB WS5 (Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos), Prudential Regulatory Authority, Bank of England