28 November, 2013
Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
BASEL
Switzerland

Submitted by e-mail: fsb@bis.org

Dear Secretariat

Second Consultative Document: Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

1. Introduction

The Japan Financial Markets Council (JFMC)[1] is grateful for the opportunity to comment on the Financial Stability Board's (FSB) second consultation on the regulation of shadow banking with respect to risks in securities lending and repos. The JFMC is supportive of the FSB's objective to introduce proportionate regulation to tackle financial stability risks posed by the shadow banking system whilst also recognising the important role these markets play to the wider financial system.

We note and welcome the changes and the developments that the FSB has made in response to the first consultation and how the policy recommendations have been refined to include proposals to exempt government collateral, which is of particular interest to market participants in Japan. We believe the first QIS was a useful step to help understand market practice that helped shape the proposals. We are also supportive of the FSB prioritising improvements in data transparency,

[1] The JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The current JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, BNP Paribas, Citigroup Japan Holdings Corp, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

which will allow well-founded assessments to be made of any buildup of risks to financial stability.

We do however believe that some of the issues highlighted in our response to the first consultative document remain valid, including some of our thoughts related to minimum standard for haircut methodologies and numerical floors on haircuts and the potentially negative impact on available liquidity.[2]

Securities lending and repos are a key source of liquidity for the global financial markets and the Consultative Document also makes this point. We therefore need to ensure that we do not take actions that might impede the supply of this liquidity, but we believe this could be the case with the current proposals as they would apply to the wider market and at a transactional level. In the worst case scenario, the minimum standard for haircut methodologies and numerical floors might cause considerable disruption to market practices and distort incentives for market participants, resulting in increased, rather than decreased, risk.

2. Difficulties in applying minimum standards to haircut methodologies

The consultative document calls for regulatory authorities to introduce minimum standards for the methodologies that firms use to calculate haircuts. This, the proposal suggests, is key to minimising the pro-cyclicality of securities financing and repo transactions. But, to the extent that liquidity is likely to suffer under the proposal, the JFMC has significant questions over whether such methodologies are practical or how effective they would be in reaching the stated objectives.

A standardised calculation of methodologies may appear attractive from a theoretical perspective but in practice there are a number of problems. Market participants are diverse and include banks, brokers, funds, investors and a number of other categories of market participants. They have varying levels of resources and expertise, as well as varying levels of access to historical data; it is difficult to envision the application of a single standard across all categories of participants. The detailed requirements proposed in the consultation, call for a methodology based on historical priced data from a period spanning a number of

[2] JFMC response to FSB's first consultative document on *Strengthening Oversight and Regulation of Shadow Banking* (see www.japanfmc.org)

years and including “at least one stress period”; this is rather vague and leaves too much to subjective interpretation.

There are also questions as to whether sufficient market data will be available to all participants. If this were not the case it could create an uneven playing field. The resulting distortions could restrict trading, hurt liquidity, and ultimately drive participants away from collateralised funding toward much riskier un-secured funding and thereby run counter to the goals of consultative document to reduce risk.

The JFMC understands that qualitative guidelines may lead to better risk modeling. But securities lending and repo transactions are privately-negotiated transactions between independent parties exercising their own discretion and judgement. Often that judgement is based on each counterparties’ unique circumstances, including levels of credit quality. Any distortion of this price setting mechanism, however well intentioned, may cause confusion, create inefficiencies and ultimately force participants to restrict or terminate trading thus reducing liquidity in this crucial market and drive participants to riskier alternatives.

Ultimately, if what might appear to be arbitrary minimum standard methodologies are applied, it may result in a majority of securities financing and repo transactions being concentrated amongst a handful of high quality players. It is not clear to the JFMC how this plausible scenario, including the likely reduction in liquidity from the market as a whole, can be reconciled with the goal of reducing risk.

3. Scepticism of the impact of numerical floors on haircuts

We understand the proposal is to reduce the pro-cyclical effect during periods of stress by limiting the buildup of leverage in the system through the introduction of numerical floors on haircuts. We also believe the numerical floors proposed in the consultation are fair and reasonable, and fully support the exclusion of government securities entirely from such calculations.

However, we remain sceptical that such numerical floors can be effectively introduced without significant pitfalls and a resulting negative impact on market confidence. The introduction of minimum haircuts would effectively force one side to the transaction to take on more exposure than the counterparty might deem adequate given considerations such as market conditions or counterparty credit quality. That would result in the counterparty either limiting transactions with the most credit-worthy partners, which may cause an overconcentration in the market and a buildup of interconnectedness between counterparties, or refraining from trades all together. Alternatively, it might drive a participant to the unsecured funding market. Either way, liquidity will suffer, and participants will face more difficulty raising funds and managing this risk in their portfolios.

If the FSB believe minimum haircuts are absolutely necessary, we would encourage that the introduction of such a regime – including the calculation of a supervisory haircut – should be conducted through the Basel Committee on Banking Supervision (BCBS) or other capital regulatory standard setters. The proposals may have an impact on the how the Basel regime treats securities financing transactions and therefore the appropriate authorities should assess the current capital rules when considering any amendments so as to avoid any duplication or negative effects caused by cumulative actions. Standard setters should also use QIS data and accumulated experience of Basel regulations to estimate the overall impact on the market in making their recommendations.

4. Greater clarity on interaction with other regulations
In introducing new regulations, it is always important to gauge how they will work in tandem with existing requirements and the potential impact of overlaps or unintended consequences.

There are a number of areas where some further clarification to the proposals would help market participants to assess the possible impact including:

- Whether the minimum methodological standards and a numerical haircut floor are being considered alongside each other and how these two proposals would interact. For example, if the scope of the haircut, as calculated under the standard methodology, is wider than the numerical floor what actions might participants need to take? Should the scope of the methodologies match the scope of numerical haircuts?

- Whether government bonds, which may not be in scope for numerical haircut floors, are being considered as part of the minimum standard methodology.

- The definitions used for the scope of the application of the haircuts (e.g. “entities subject/not subject to regulation of capital and liquidity/maturity transformation” and “regulated intermediaries”).

- Whether the proposal of numerical floors for haircut is intended to be implemented through the regulatory capital regimes for regulated intermediaries or minimum margin regimes for regulated intermediaries.

We would welcome further clarification on the above items so that an effective dialogue can be held between standard setters and the industry in producing a sensible regulatory framework.

5. Government bonds and other non-government collateral
Finally, we would like to highlight our concern on the impact of the proposal on high quality collateral assets, including government securities. The new global regulatory landscape , including reforms such as the Basel III liquidity coverage ratio and margin requirements of non-centrally cleared derivatives, are creating a heightened demand for these types of assets.

The JFMC is grateful that a number of exemptions from the scope of proposed numerical floors, including government collateral, have been put in place. But we believe that transactions backed by government securities should also be excluded from the proposed minimum methodological standards requirements. As stated in our response to the first consultative document, applying minimum methodological standards and numerical floors on haircuts to liquid government bond markets is likely to have a significant negative impact on the liquidity of the repo and securities lending markets. This could result in a number of unintended consequences, including the possible disruption of market operations of central banks which might ultimately have an impact on the cost of funding by governments.

Market conditions for non-government collateral, such as corporate bonds, securitisation products and equity, vary considerably across jurisdictions; this includes the liquidity available, the size and depth of market, and also the stage of market development and market conventions. We therefore encourage the FSB to make an assessment of the potential impact of the proposals on different markets. It is important to avoid a situation in which a well-intentioned regulation for one market leads to unintended consequences in another. Liquidity within the Japanese market for non-government bonds remains weak and transaction volumes are low. Market participants are therefore trying to improve liquidity and encourage the development of the market; introducing measures that might dampen this activity could have wider negative impacts.

6. Conclusion

In summary, the JFMC is pleased that the FSB has revised its policy recommendations to limit the scope of numerical haircut floors including the exemption of government collateral. We also welcome empirically-based policy making. We do however have considerably doubts about applying minimum standards to haircut methodologies and the numerical haircut floor as we believe a number of risks to financial stability could build up. We therefore urge the FSB to look again at this area. Further clarity on a number of points as set out above would also be helpful for market participants to assess the impact of the proposals. If you have any queries about any of our comments we would be happy to provide further information.

Yours faithfully,

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