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Comments on the Financial Stability Board's Consultative Proposals in Annex 2 of "Strengthening Oversight and Regulation of Shadow Banking: Policy framework for Addressing Shadow Banking Risks in Securities Lending and Repos"

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative proposals set out in Annex 2 of "Strengthening Oversight and Regulation of Shadow Banking: Policy framework for Addressing Shadow Banking Risks in Securities Lending and Repos", released on 29 August 2013 by the Financial Stability Board ("FSB").

<General comments>

Scope of application - Entities

Transactions conducted by regulated intermediaries subject to the prudential regulation should be excluded from the scope of not only the framework of numerical haircut floors but also the entire proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions (the "Regulation") including the minimum standards for methodologies to calculate haircuts. The objective of the Regulation is "to limit the build-up of excessive leverage outside the banking system" (page 22 of the "Strengthening Oversight and Regulation of Shadow Banking: Policy framework for Addressing Shadow Banking Risks in Securities Lending and Repos" (the "Document")). While the framework for numerical haircut floors explicitly excludes the transactions between regulated intermediaries (e.g. banks), the minimum qualitative standards for methodologies do not explicitly exclude them. It is worthy to note that banks are already regulated by capital ratio, leverage ratio and liquidity requirements under the Basel III framework so as to limit the build-up of excessive leverage and reduce pro-cyclicality. Therefore, the FSB should thoroughly consider whether including banks into the scope of the Regulation is appropriate in light of its objective, as well as whether the Regulation and the capital and liquidity requirements complement one another in a meaningful manner in order to ensure sufficient consistency across financial regulatory regimes and prevent duplicative regulation on specific entities.

Although the objective of the numerical haircut floors is to regulate excessive funding by entities

that are not subject to the prudential regulation ("unregulated intermediaries"), the FSB is seeking to use an "indirect" approach by adjusting the regulatory capital requirements imposed on regulated intermediaries. As discussed in detail in Q18, this approach would undermine the regulatory capital framework so it should be revised.

To make the Regulation more effective, capturing a comprehensive picture of developments in securities financing market and identifying the risks associated with securities financing activity as well as trading entities through transaction data collection and analysis should first be prioritized. Considering the result of such analysis and potential market impact, it should be discussed that which entities need to be subject to the Regulation and how the Regulation should be. If transactions executed by unregulated entities are the source of systemic risk, for instance, the FSB should first consider developing a framework that directly regulates such unregulated entities.

Nonetheless, we support the FSB's approach of taking measures intended to get a broad picture as described in the Document because such efforts are considered to be useful to optimize the effectiveness of regulation. In such cases, the FSB should consider to avoid imposing an excessive burden on market participants in their reporting of transaction data.

Scope of application - Transactions

The application of both the minimum standards for methodologies and numerical haircut floors proposed in the Document should be limited to non-centrally cleared securities lending and repos. As for centrally-cleared transactions, central counterparties ("CCPs") have margin systems which would limit the build-up of excessive leverage, and the mitigation of counterparty risk reduces pro-cyclicality. Hence, the Regulation should not be additionally applied to centrally-cleared transactions. Moreover, the FSB should not require the overly burdensome standards to the CCPs. For example, CCPs operating under appropriate supervision of national authorities should be excluded from the scope of the Regulation.

Implementation of the Regulation by national authorities and its timing

The Regulation is expected to be incorporated into the regulations of the respective jurisdictions through the system establishment/legislation processes and applied to individual market participants. However, given that market practices, composition of participants, market structure and other aspects vary across jurisdictions, the FSB should ensure sufficient flexibility to each jurisdiction to reflect its market characteristics in implementation process.

In addition, the establishment of the relevant national systems for the implementation would give rise to issues associated with the application of the regulations to cross-border transactions. It is considered necessary for national authorities to, prior to embarking on the establishment of the relevant systems, identify and reach their consensus on any potential issues relating to cross-border

transactions, such as duplicative application of regulations, regulatory inconsistency across jurisdictions, and extraterritorial application of regulations.

After the finalisation of the Regulation, each jurisdiction will need lead time prior to the application of the Regulation to market participants through the system adjustment/legislation processes, in order to discuss legislative issues, work on legislation in its own jurisdiction, to address necessary systems development and take other necessary actions to comply with such legislation. In this view, we respectfully request that at least a 3 year- preparation period should be set aside after the finalisation of the Regulation to allow implementation before it can be applied.

Minimum qualitative standards for methodologies used by market participants to calculate haircuts

It is our concern that if the FSB or national authorities provide specific methods in minimum qualitative standards for methodologies of detailed definitions or mandate the application of such standards, it may eventually dictate market haircuts even though specific numerical haircut floors are not set. The consultative proposals state that the minimum standards for methodologies would apply alongside the proposed framework for numerical haircut floors. However, there are overlaps in the scope of transactions between methodology standards and numerical haircut floors. This may give rise to issues in practice unless it is specified which of the two supersedes the other. Our view is that the minimum standards for methodologies should be used as a kind of reference, rather than being applied as a regulation.

The scope of application of the minimum standards for methodologies should be consistent with the numerical haircut floors framework. The grounds for exempting securities financing transactions backed by government securities from the framework of numerical haircut floors should also be applied to the minimum standards for methodologies. Consequently, transactions backed by government securities should also be excluded from the minimum standards for methodologies. Even if such exemption is not allowed under the general international rules, the FSB should give discretion to national authorities in implementing the minimum standards for methodologies so that they can allow the exemption of government securities if they deem it as appropriate.

As noted in the section of 4.1 “Scope of application” in Annex 2 of the Document, price movements in government securities are not considered pro-cyclical except for special cases. Further, in stressed market conditions, market participants are inclined to give preference to repos on government securities as their funding tool. Given that there is not much difference in the liquidity of repos on government securities in both normal period and in stress period, it is not considered meaningful to impose haircuts on these transactions for the purpose of reducing pro-cyclicality. Additionally, imposing haircuts on these transactions would have a material negative impact on the liquidity and functioning of core funding markets both in normal and stressed conditions.

<Specific comments>

The section below provides our comment on specific questions set forth in Annex 2 of the Document.

(Q2 & Q3)

Similar to the framework of numerical haircut floors, transactions between regulated intermediaries should be excluded from the scope of application of the minimum standards for methodologies to avoid overlapping regulations. Likewise, as previously discussed, transactions backed by government securities should also be excluded from the minimum standards for methodologies as well as the numerical haircut floors. Given the fact that some jurisdictions currently do not have practices similar to the minimum standards for methodologies, a flexible regulatory framework needs to be established, reflecting practices and market conditions surrounding repo transactions in the respective jurisdictions.

In applying national haircut regulations to cross-border transactions or outside its own jurisdiction, sufficient coordination should be made among national authorities in determining the details and timing of application of such regulations to prevent any confusion resulting from the application of regulations which are duplicative and conflicting.

It is our concern that, if excessive regulations are implemented, an unduly high level haircut, combined with other factors, could cause the rise of repo execution costs, resulting in the escalation of funding costs.

(Q4)

In order to implement (i) minimum standards for methodologies and (ii) the proposed framework for numerical haircut floors, each jurisdiction will need to allow a sufficient phase-in period, after the finalisation of the Regulation, to determine in detail how to implement the Regulation into its own jurisdiction and to undertake the legislation process as well as to enable market participants to take necessary actions to comply with the requirements, including systems development. Therefore, at least a 3-year phase-in period should be set aside after the finalisation of the Regulation for implementation.

As Japan does not have common methodologies used by market participants to calculate haircuts, it will require significant time to perform risk analysis, develop new methodologies to calculate haircuts and reach consensus among stakeholders. Similarly, the implementation of the numerical haircut floors will call for considerable time to, among other things, determine the haircut implementation timeline, including data collection and risk analysis.

(Q5 & Q6)

The scope of application of the minimum standards for methodologies should be limited to financing transactions by unregulated intermediaries. In addition, as mentioned above, transactions backed by government securities should also be excluded from the scope. With regard to these transactions, common practices currently prevailing in the markets should be respected.

(Q8 & Q10)

The proposed scope of application of the numerical haircut floors is considered appropriate to achieve the objective of such application, and to effectively limit excessive financing activities by unregulated intermediaries.

Given experiences from past financial crises, such crises are highly likely to first prompt fire sales. Therefore, instruments which are more likely to be susceptible to fire sale, such as repos and securities lending transactions collateralised with securitised products and equities, should be targeted in the scope of application of the numerical haircut floors.

(Q13)

The FSB proposes to exempt cash-collateralised securities lending transactions from the framework of numerical haircut floors if the lender of the securities makes cash collateral reinvestment and meets certain conditions. However, it is difficult for the bank, the funding provider, to identify whether the lender of the securities meets such conditions. Therefore, if this proposed exemption is to be implemented, we request that banks should be able to utilise this exemption if the securities lender provides a representation that it meets the specific conditions, so as to avoid an undue burden on the bank, the funding provider, to confirm the status of the securities lender.

(Q14)

Securities financing executed for the purpose of meeting margin requirements at a CCP should be considered separately from highly-leveraged transactions, and therefore should be exempted from the proposed framework of numerical haircut floors.

(Q15 & Q16)

The FSB proposes to exempt collateral upgrade transactions from the framework of numerical haircut floors if the lender of the securities meets certain conditions. However, it is difficult for the bank, the funding provider, to identify whether the lender of the securities meets such conditions. Therefore, if this proposed exemption is to be implemented, we request that banks should be able to utilize this exemption if the securities lender provides a representation that it meets the specific conditions, so as to avoid an undue burden on the bank, the funding provider, to confirm the status of

the securities lender.

(Q17)

It is our concern that introducing the proposed framework of numerical haircut floors may impose a significant management burden on financial institutions, increasing execution costs to a level more than expected.

(Q18)

We do not support the proposed indirect approach to implement the proposed numerical haircut floors through the regulatory capital framework applied to banks.

In our understanding, the framework of numerical haircut floors intends to promote and establish minimum haircut practices by using a structure that creates an incentive to "raise the haircut level to avoid the capital charge" (as stated in (iii) in Box of the section 4.5).

However, the original objective of the framework of capital adequacy ratio is to require banks to hold capital at the level proportionate for the risks they are exposed to. The above-mentioned regulation which solely intends to create a new incentive structure may cause banks to misjudge that risks exist in areas where they actually do not. Such misjudgment may attract unreasonably high capital charges, resulting in a distortion in the regulatory capital framework. (For example, Option 1 set out in the Box in section 4.5, treats transactions with haircut below the numerical floor as unsecured for capital purposes, and calculates the adjusted value of collateral as nil (AC=0).)

Moreover, newly establishing such an incentive structure will not contribute to increasing risk sensitivity but rather create a cliff of capital charge around the numerical haircut floors, which will make the regulatory framework for banks complicating. Therefore, this policy approach is not considered to be in line with the direction of current discussions by the Basel Committee on Banking Supervision[1].

It is proposed that the FSB should discuss regulation over business practice separately from banks' prudential regulation, and reconsider alternative implementation approaches that will not result in imposing undue capital charges on banks.

[1] BCBS258 (July 2013): Discussion paper: The regulatory framework: balancing risk sensitivity, simplicity and comparability.