EFAMA REPLY TO THE FSB CONSULTATION ON A POLICY FRAMEWORK FOR ADDRESSING SHADOW BANKING RISKS IN SECURITIES LENDING AND REPOS

EFAMA[1] welcomes the possibility to respond to the consultation organised by the Financial Stability Board on a "Policy framework for addressing shadow banking risks in securities lending and repos". Investment funds are playing a significant role in the securities lending markets (where investment funds act as lenders of securities) and on the repo markets.

As the representative body for the European investment funds industry, we are therefore committed to bring our active contribution to the important work undertaken by WS5 and hope that our comments on the Consultation Paper will help the FSB in developing sound policy recommendations for these important markets.

Before answering the specific question raised in the Consultation Paper, we wish to reiterate our disagreement with the strong focus put on fund managers in the already adopted policy recommendations on securities lending and repos. We genuinely fail to understand why the reporting requirements to end-investors envisaged under policy recommendation n°5 should apply exclusively to fund managers and not to other market participants also involved in securities financing transactions, such as pension funds or insurance companies, for instance. Equally unclear to us is the link between these reporting requirements and the mitigation of financial stability concerns. We indeed have serious doubts about the potential of fund reporting on securities financing transactions to be useful for dampening systemic risks and procyclical effects associated with those activities. Moreover, we strongly believe that the level of disclosures recommended by the FSB is by far too sophisticated for retail investors in particular and is, therefore, unlikely to help them in making well-informed investment decisions.

Executive summary

- We strongly support the objective of the FSB of collecting more granular data on the functioning of securities lending and repo markets and welcome the policy recommendations developed in this area , to the extent that they are well calibrated and leveraging as much as possible on existing data collection processes and market infrastructures. **Priority should be**

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 60 corporate members about EUR 15 trillion in assets under management of which EUR 9.5 trillion managed by 55,000 investment funds at end September 2013. Just over 35,500 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

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given to the implementation of these policy recommendations in order for regulators to gain a more comprehensive picture of how securities lending and repo markets are evolving and of the risks associated with behavior patterns in these markets before deciding on policy recommendations on managing collateral chains through haircuts or otherwise.

- In principle, we believe that regulation that tackles leverage directly rather than indirectly through imposing minimum haircuts is a better way to address the concerns raised by the FSB and therefore represents a more effective approach to risk mitigation. In this context, we wish to reiterate that the conditions under which European investment funds are authorised to engage in securities lending or repo transactions are already subject to regulation at EU and national levels which effectively prevents the build-up of excessive leverage[2].

- We believe that there will be more overall benefit from mandating robust and well calibrated methodologies to be used by market participants to calculate haircuts (as is already the case for investment funds in Europe) than from imposing mandatory haircut floors.

- We are concerned that imposing mandatory haircuts for securities lending and repos may have the unintended consequence of becoming the *de facto* norm for those markets. Should mandatory haircuts nevertheless be introduced, we would then have a clear preference for haircut floors to be set at conservative backstop levels, i.e. below the prudent market standards for actual haircuts in normal circumstances. From that perspective, the numerical floors proposed by the FSB in its consultation paper appear to be sensible.

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?

As a principle, we believe that regulation that tackles leverage directly rather than indirectly through imposing minimum haircuts is a better way to address the concerns raised by the FSB and therefore represents a more effective approach to risk mitigation.

In this context, we wish to reiterate that securities lending and repo transactions by investment funds in Europe are already governed by extensive sets of rules (UCITS, AIFMD, ESMA Guidelines on ETFs and Other UCITS issues) which – importantly – may have the same economic effect as banking

[2] For further details on the relevant applicable rules for European investment funds, please refer to our detailed answer to the questions of the Consultation Paper and to EFAMA's response to the FSB Consultation on Strengthening oversight and regulation of shadow banking dated of 14 January 2013:
http://www.efama.org/Publications/Public/Money_Market_Funds/EFAMA_reply_to_FSB_Strengthening_oversight__Regulation_of_SB_entities.pdf

regulation. As a result, the scope for leverage and incremental procyclicality arising from these activities is fairly limited. In particular, under the ESMA guidelines, cash collateral received from securities lending can only be placed on deposits, invested in high-quality government bonds, used for reverse repos transactions with regulated credit institutions or invested in short term Money Market Funds[3]. Similarly, due to the requirement for non-cash collateral not to be sold, reinvested or pledged, rehypothecation of assets is generally excluded[4]. The ESMA guidelines also mitigate the risk of improper valuation of collateral by providing for valuation on at least a daily basis and making the acceptance of collateral displaying high price volatility more difficult[5].

Q2. What issues do you see affecting the effective implementation of the policy recommendations?

We are concerned that the scope of application of the proposed framework of numerical haircut floors is putting regulated investment funds at an unjustified disadvantage compared to other market participants which are exempted from such framework. Regulated investment funds are subject to strict regulatory requirements for the management of their liquidity and the prevention of building-up of excessive leverage. Like banks or broker/dealers, regulated investment funds should therefore be considered as "regulated intermediaries" and benefit from the exemption from the application of numerical haircut floors in the same manner as banks and broker/dealers (see also our reply to question 7 below).

Q3. Please address any costs and benefits as well as potential material unintended consequences arising from the 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.

Imposing mandatory haircuts may have unintended consequences due to a conflict in methods and outcomes between protecting investors and protecting the system. As a principle, we believe that investors should have the ability to make reasonable risk-based determinations of the appropriate level of haircut based on their counterparty and the volatility of the securities on loans and used as collateral. An investor may reasonably choose to take a lower haircut on collateral from a high-quality counterparty, or when the collateral used is highly liquid or highly correlated with the securities on loan. Higher mandatory haircuts may seem appropriate from a systemic risk perspective but they would reduce or eliminate the attractiveness of the transaction for investors and the counterparties.

Moreover, specific minimum haircut 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.

[3] Article 43j) of the ESMA guidelines on ETFs and other UCITS issues (ESMA 2012/832).
[4] Article 43i) of the ESMA guidelines on ETFs and other UCITS issues (ESMA 2012/832)
[5] Article 43b), ESMA Guidelines on ETFs and other UCITS issues, (ESMA, 2012/832)

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

In our view, regulatory initiatives aiming at collecting more granular data should be the first priority before deciding on policy recommendations on managing collateral chains through haircuts or otherwise, based on data and information that regulators will be able to collect.

To the extent that operational processes and IT systems may have to be adapted, notably to reflect mandatory minimum haircuts, an appropriate phase-in period (which, in our view, should not be less than 12 months) would allow for market participants to implement the policy recommendations.

It is, however, very difficult to be more specific at this stage about the appropriate length of this phase-in period, given that it will essentially depend on how the final policy recommendations that will be adopted by the FSB will then be transposed into regional or national regulations.

Minimum standards for methodologies used by market participants to calculate haircuts

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 market practices?

Following the ESMA guidelines, UCITS are under the obligation to "*have in place a clear haircut policy adapted for each class of asset 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 45*[6]*. 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".*[7]

In our view, the list of minimum standards and factors described in Section 2 appears to be comprehensive and we do not see other important factors that should be taken into account in setting risk-based haircuts. Most of the factors identified in the Consultation Paper are already routinely used by UCITS and other types of regulated investment funds as part of their haircut policies and therefore seem to be aligned with current market practice for investment funds.

[6] Article 45 of ESMA Guidelines provides that "*A UCITS receiving collateral for at least 30% of its assets should have an appropriate stress testing policy in place to ensure regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS to address the liquidity risk attached to the collateral. The liquidity stress testing policy should at least prescribe the following:*

a) Design of stress test scenario analysis including calibration, certification & sensitivity analysis;
b) Empirical approach to impact assessment, including back-testing of liquidity risk estimates;
c) Reporting frequency and limit/loss tolerance threshold/s; and
d) Mitigation actions to reduce loss including haircut policy and gap risk protection."

[7] Article 46 of ESMA Guidelines on ETFs and other UCITS issues, (ESMA 2012/832)

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

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?

We believe that the market practice is already to calculate margin and haircut requirements on the portfolio basis.

We would also suggest taking the following elements into account:

1. The notion of "Gross Exposure to one single counterparty" could be taken into account as it would help reducing chain reactions in case of default of that counterparty.

We anticipate potential sudden "jumps" in the haircut values and frantic margin calls in stressed markets. Applied haircuts would then be higher than the ones defined contractually or the one defined by the model. We would then advocate mitigating not only the magnitude, but also the speed of the potential haircut increase to avoid excessive pressure on weakened market participants.

The inclusion of this factor could reduce the building of excessive pressure against a counterparty, protect the market and allow for an efficient and competitive funding market.

2. As market participants use baskets of assets which can be chosen by the counterparty as collateral, these baskets could be used to create netting opportunities in case of opposing transactions.

The incorporation of additional obligation for portfolio margins could however hinder market participants to calculate in time the portfolio margin requirements, consequently requiring careful calibration.

3. We do not feel comfortable with the notion of creation of "hypothetical portfolio calculation". It is extremely ambitious to expect market participants to provide the competent authorities on a regularly basis with hypothetical portfolios which could be used by the regulators to identify any market-wide changes in levels of margin requirements over time as any outliers firm with low margin requirements. The submitted parameters of the hypothetical portfolios could only reflect the market conditions based on historical data or appropriate time simulations covering more information than one stress period.

In the situation where such hypothetical portfolios could not be extrapolated in the future, we fear that the global standard setter could force market participants to use harmonized regulatory models without any possibility for the market to use own margins methodologies.

Consequently, market participants should have the flexibility to develop and use their own margin requirement portfolios which are in line with the current law/market practice and with the mentioned recommendations.

Numerical floors on 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?

Yes. As already mentioned above in our answer to Question 2, we believe there is a need to clarify the scope of application of the proposed framework of numerical haircut floors in particular with a view to better defining which entities ought to be considered as "regulated intermediaries" as opposed to "entities which are not subject to regulation of capital and liquidity/maturity transformation".

In our view, there is a strong case to consider that regulated investment funds – like banks or broker/dealers – belong to the category of "regulated intermediaries" described in the consultation paper and should therefore be exempted from the scope of application of the proposed framework of numerical haircut floors.

Indeed, even though they are not as such subject to capital requirements, it is important to take into account the fact that most securities lending and repo activities by investment funds in Europe are already governed by an extensive set of rules which effectively limit the build-up of excessive leverage as well as the other financial stability risks identified by the FSB in relation to these activities. They are also subject to detailed rules in terms of management of their liquidity risks (as already mentioned above in our answer to question 1).

Consequently, regulated investment funds in Europe may be deemed to be subject to regulatory requirements which are equivalent in their effects to the rules applicable to banks or broker/dealers and should therefore qualify as "regulated intermediaries".

Q8. Would the proposed scope of application for numerical 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?

Please refer to our answer to Question 7 above.

Apart from that, we do not think that the scope of application should be further expanded and we agree with the FSB proposal that securities financing transactions backed by government securities should be left out of scope.

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.

We are of the opinion that it is best practice for securities lending and repo transactions to be fully collateralized (which, in most cases, already corresponds to market practice for investment funds) but we question whether mandatory haircuts on top of that level would achieve more good than the possible danger of becoming the de facto norm or reduce even more collateral availability. We believe that there will be more overall benefit from mandating robust methodologies to be used by market participants to calculate haircuts (as already applicable to investment funds in Europe) than from requiring mandatory haircut floors (please refer also to our answer to Question 3 above).
Should the Financial Stability Board nevertheless decide that there is a need to introduce mandatory haircuts, we would then have a clear preference for haircut floors to be set at conservative backstop levels, i.e. below the prudent market standards for actual haircuts in normal circumstances. From that perspective, the numerical floors proposed by the FSB in table 1 appear to be appropriate.

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?

No. We do not see the need to take into account additional factors in setting numerical haircut floors as set out in table 1.

We believe, however, that it would be useful to clarify the notion of "other assets within the scope of the framework" to which reference is made in table 1. It is indeed unclear to us which categories of assets would fall under that definition and would therefore be subject to the 7,5% minimum haircut foreseen by the FSB.

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?

We do not anticipate major difficulties in applying the numerical haircut floors at the level of the portfolio provided that those are set at conservative backstop levels as proposed in table 1 and that the notion of portfolio is applied at sub-fund's (compartment) level for umbrella funds.

Cash-collateralised securities lending

Q13. What are your views on the merits and impacts of exempting cash-collateralized 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 funds 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?

We welcome the approach proposed by the Financial Stability Board consisting in excluding cash collateralised securities 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 as foreseen in the Consultation paper.

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?

We would indeed welcome that approach.

Funds are usually entering into securities lending agreements to maximize the performance of their funds and are, consequently, collateral receivers. Funds are also often not able to meet Clearing Members or Central Clearing Platforms eligibility requirements.

At EU level ESMA has taken a stance in the context of the UCITS regulation according to which cash received by UCITS in the course of repo trades shall be treated as collateral and shall be bound by the same restrictions on reuse or reinvestment. This effectively eliminates the possibility for UCITS to use cash from repos for collateralisation of OTC derivative transactions and hence makes it very difficult to participate in the central clearing of OTC derivatives where cash collateral is needed for the provision of the variation margin.

We are convinced that proceeds from repo transactions should not be treated as collateral from both legal and economic perspective:

- Legally speaking, the concept of repos is clearly different from securities lending as it provides for the transfer of the economic ownership of the relevant assets subject to a repurchase obligation at a future point in time.
- From the economic point of view, repos are predominantly used by European investment funds as financing transactions e.g. to bridge liquidity gaps in a more cost-efficient way than unsecured bank credits. This is a profound difference to securities lending which serves the sole purpose of generating additional profits for the fund from the lending fees or interests on cash collateral which could lead to creating further counterparty risks.

Collateral upgrade transactions

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.

We agree with the Financial Stability Board proposal that securities lenders should be exempt from the proposed numerical haircut floors on "collateral upgrade" transactions if they are unable to re-use collateral securities received against securities lending and therefore do not obtain financing against the collateral.

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?

Again, we agree with this proposal and note that, under the ESMA guidelines, non-cash collateral received by UCITS cannot be sold, reinvested or pledged[8].

Implementation approaches

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 (ii) numerical haircut floors separately.

Implementation timing should be coordinated with the progress made on EMIR. EMIR forcing the collateralization of every derivatives transaction and this consultation highlighting the focus set globally on exchanging good quality collateral are perfect example of the need for coordination.

Brussels, 28 November 2013

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[8] Article 43j) of ESMA guidelines on ETFs and other UCITS issues, (ESMA 2012/832).