European Fund and Asset Management Association

EFAMA RESPONSE TO THE FSB CONSULTATION ON STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING

EFAMA welcomes the opportunity to submit its views on the FSB Consultation on strengthening oversight and regulation of shadow banking.

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 59 corporate members approximately EUR 14 trillion in assets under management of which EUR 8.7 trillion was managed by approximately 54,000 funds at end September 2012.[1]

Representing the European investment funds industry, an already highly regulated part of the financial sector, EFAMA is supportive of the objectives pursued by the Financial Stability Board (FSB) to identify and close any regulatory gaps as well as inefficiencies in the supervision of the financial sector in general, with a view to mitigating systemic risks and reducing the possibilities of regulatory arbitrage.

We very much support the approach taken by the FSB to adopt a targeted methodology by narrowing down its focus to the portion of the shadow banking system that can be defined as a system of credit intermediation that involves entities and activities outside the regular banking system, and raises systemic risk concerns and/or regulatory arbitrage concerns, while not inhibiting sustainable non-bank financing models that do not pose such risks. We also support the view that the development and adoption of new regulatory measures should be guided by the five general principles proposed by the FSB, i.e. focus, proportionality, forward-looking and adaptability, effectiveness, and assessment and review.

We also find it extremely important that the authorities aim at gathering a good understanding of the potential impact and possible unintended consequences of targeted proposals of new regulations on the non-bank financial activities and players in general, and on the financing of the real economy, in particular. This means that systemic risks should be regulated in a way that best addresses these risks without threatening the existence and competitiveness of these activities or entities.

Furthermore, it is widely recognized that the concept of "shadow banking" is a misnomer that seems to imply that the targeted entities and activities are somehow less legitimate or less transparent than

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banking activities. We therefore believe that the authorities should accept to move outside the shadow banking system the activities and entities that will be subject to new regulatory rules in response to the G20 Leaders' call to strengthen the oversight and regulation of the shadow banking system. In particular, we strongly recommend that the FSB takes off money market funds (MMFs) from the shadow banking system once the authorities will have implemented the IOSCO recommendations.

In what follows, we have divided our comments to the FSB consultative documents in three sections covering the IOSCO recommendations on MMFs, the policy framework for strengthening oversight and regulation of shadow banking entities, and the policy recommendations to address shadow banking risks in securities lending and repos.

1. Comments on the IOSCO recommendations on MMFs

Recommendation 1: Money market funds should be explicitly defined in CIS regulation.

We fully agree with the proposal to define MMFs as *"investments funds that seek to preserve capital and provide daily liquidity, while offering returns in line with money market rates"*.

We are of the view that only the investment funds that carry the MMF "label" should be subject to the specific regulatory requirements applying to MMFs. In other words, an investment fund should comply with all those requirements to be allowed to use the MMF "label". In our view, this is the best way to enhance the benefits of the regulation specific to MMFs. It is also a pragmatic approach of differentiating between MMFs and other funds that follow similar investment objectives but are exposed to more risks.

In addition, EFAMA is in favor of authorizing the creation of types of MMFs following the two-tier approach introduced by CESR/ESMA in Europe, which distinguishes between

- "Short-term MMFs" which operate a very short weighted average maturity and weighted average life; and

- "MMFs" which operate a longer weighted average maturity and weighted average life

The main advantage of a two-tier system is to give investors the possibility of choosing between two types of MMFs according to their needs and preferences. .

It should be stressed, though, that the core regulatory requirements should be the same for both types of MMFs, in particular regarding stress testing and "know your customer" principles.

<u>Recommendation 2: Specific limitations should apply to the types of assets in which MMFs may invest and the risks they may take.</u>

We strongly believe that in Europe the CESR/ESMA guidelines provide a robust framework to limit the main risks to which MMFs are exposed, i.e. interest rate risk, credit/credit spread risk and liquidity risk.

Among other things, the reduction in the weighted average maturity (to no more than 60 days for Short-term MMFs and 6 months for MMFs) limits the overall sensitivity of the funds' NAV to changing interest rates, and the reduction of the weighted average life (to no more than 120 days for Short-Term MMFs and no more than 1 year for MMFs) limits credit and credit spread risk. Overall, the requirement to invest in high quality money market instruments reduces credit risks. In practice, the requirements from the CESR/ESMA guidelines and the UCITS Directive oblige MMF managers to keep high-quality and liquid portfolios to avoid running into liquidity difficulties.

<u>Recommendation 3: Regulators should closely monitor the development and use of other vehicles similar to money market funds (collective investment schemes or other types of securities).</u>

As explained above, EFAMA proposes to limit the use of the MMF "label" to the funds complying with the MMF regulation in order to create a label of top-quality and to ensure that only MMFs benefit from special investor protection measures.

Having said this, we strongly agree that regulators should closely monitor the development in this segment of the market to avoid unfair competition from vehicles which would claim to have the same quality and characteristics as MMFs.

<u>Recommendation 4: Money market funds should comply with the general principle of fair value when valuing the securities held in their portfolios. Amortized cost method should only be used in limited circumstances.</u>

We recognise that marked-to-market valuation offers high transparency to investors, as they know that the price at which they subscribe or redeem does reflect market prices. However, we continue to believe that a limited use of amortized cost prices can be justified:

- First, money market funds tend to hold money market instruments to maturity. Furthermore, many money market instruments, for example commercial paper and certificates of deposit, do not have traded market prices.

- Second, the use of a "shadow price" should allow CNAVs to provide price transparency to investors and to switch to the shadow price when the amortization method result in a "material discrepancy" between the amortised price of the portfolio and an alternative estimate of its market price. That alternative estimate should be based on a well accepted calculation method.

- Third, the cost involved in requiring mark-to-market pricing, in particular for securities very close to maturity, would not be justified. This concern is valid for all MMFs.

- Finally, amortized cost can be used by banks for financial assets kept to maturity and generating payments of principal and interest on the principal outstanding.

Regarding the conditions under which the use of amortized cost accounting should be allowed, we believe that the ESMA's Guidelines Concerning Eligible Assets for Investment by UCITS provide an effective framework for limiting the use of amortized cost prices, in particular in view of the specific risk constraints imposed on money market funds to protect investors, such as maximum WAM, maximum WAL, minimum liquidity requirements and minimum credit quality requirements. We would also like to emphasize that too great a reduction in the permitted maturity of high-quality money market instruments which may be amortized has potential to damage those parts of the real economy which fund themselves in these markets.

Recommendation 5: MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the funds accounts.

EFAMA supports this recommendation.

Recommendation 6: Money market funds should establish sound policies and procedures to know their investors.

In general, we consider that MMFs should have in place an internal system to be able to meet reasonably foreseeable liquidity demand of their clients, taking into account client concentration and client segments, industry sectors and instruments, and market liquidity positions.

We also very appreciate the view taken by IOSCO that practical impediments may restrict the funds' ability to monitor its investors and the concentration of its investor base, especially in the case of omnibus accounts and MMF portals. Against this background, we strongly believe that any reform ought not to take the form of formal limits *per se*, but rather of an obligation on MMFs to know their investor base in order to manage concentration risk. We would also support sound procedures to manage liquidity risk by monitoring redemptions and subscriptions very closely but not a mandatory requirement to maintain an individual shareholder register at the fund level.

Recommendation 7: Money market funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.

We agree that MMFs should hold a certain percentage of their assets in cash or securities accessible very quickly, to be able to meet redemptions without incurring losses that could affect the remaining shareholders. Against this background, the introduction of mandatory portfolio liquidity

requirements is appropriate. However, when the regulation allows for two types of MMFs, we consider that the liquidity requirements should not be same across both categories.
We also believe that regulators will have to address how to define “liquid” assets. One possible approach would be to define “liquid asset” in terms of their effective maturity and to differentiate the definition for the weekly and monthly liquidity ratios.

It should also be clear that the regulatory requirements would only apply when a security is purchased. A temporary difference should be acceptable if the liquidity position is used to meet a redemption that causes the fund liquid assets to fall below the liquidity ratios.

Recommendation 8: Money market funds should periodically conduct appropriate stress testing.

EFAMA fully supports this recommendation.

Recommendation 9: Money market funds should have tools in place to deal with exceptional market conditions and substantial redemptions pressures.

We consider that the provision of the UCITS Directive[2] that establishes that national supervisors should be empowered to suspend the redemption of units or shares, provided that such suspension is justified for the protection of the unit-holders, has put in place an appropriate tool to cope with substantial redemptions pressures.

On the other hand we consider that the potential benefits of generalizing redemption in-kind mechanisms would be very small compared to the difficulties and drawbacks of such measures.

We also are of the view that the use of gates should only be conserved as a last resort mechanism to be used with caution given its potential negative impact on the overall liquidity in the system as well on the perception that MMFs should be able to offer daily liquidity.

Recommendation 10: MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and to internalize the costs arising from these risks. Regulators should require, where workable, a conversion to floating/ variable NAV. Alternatively, safeguards should be introduced to reinforce stable NAV MMFs’ resilience and ability to face significant redemptions.

We continue to believe that the potential risks posed by CNAVs in Europe should not be overestimated. In addition, it is not clear that the investors who find it convenient and efficient to diversify their assets in CNAV today will decide to move to VNAVs, as requiring a VNAV will reduce or eliminate the features of MMFs that make them attractive as a cash management vehicle to many

[2] Article 45, paragraph 2 of the UCITS Directive.

investors of CNAV. A phasing out of CNAV MMFs would also mean to clients a lower risk diversification and the requirement to build up significant own risk management resources. Therefore, as noted by IOSCO, we believe that regulators should pay due consideration to the potential negative consequences of a move to variable NAV. Against this background, the best way forward to address the perceived vulnerabilities of CNAVs would be to introduce additional safeguards to reinforce their resilience and ability to face significant redemptions.

Among the different mechanisms considered by IOSCO, we believe that the option of imposing a liquidity fee on CNAVs during stressed market conditions is the most appropriate as asking investors to pay for the cost of liquidity would reduce the strains created by heavy redemptions and the need to fire sale securities.

On the other hand, we have strong reservations against the proposal that CNAV funds should accumulate capital requirements or buffers as this policy approach would destabilize very much the business model of MMFs, especially in a situation like today, where money market rates are at historically low levels. In addition, the design and implementation of capital buffers on CNAV funds would give rise to numerous questions which will be difficult to answer, including the potential size of the buffer, whether it is high enough and to whom it actually belongs when investors redeem shares. MMFs need to be fully transparent and easy to be explained to investors. Complex features relating to buffers would confuse the investment community.

Recommendation 11: MMF regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings.

We fully support the proposals that aim at reducing the risks of over-reliance of fund managers on credit ratings and introduce a requirement for the managers not to rely solely or mechanistically on external credit ratings for assessing the creditworthiness of a fund's assets. External credit ratings may be used as one factor among others in this process but should not prevail.

In this context, we strongly believe that the use of credit rating agencies to determine whether or not a MMF may invest in a money market instrument should also be reconsidered, as the significance of ratings of credit rating agencies in CESR's guidelines on MMF is overstated.

What matters is that management companies employ a risk-management process which enables them to monitor and assess the credit quality of the money market instruments they invest in, within a framework that should not be limited *a priori* by ratings awarded by credit rating agencies. In other words, the responsibility of the quality assessment of a money market instrument should lie with the management company. Therefore, in carrying out its due diligence, the management company should be able to overwrite the credit rating of an instrument if it can conclude that the instrument is of high quality, taken into account a range of factors such as the liquidity profile and the nature of the asset class represented by the instrument.

Finally, we would also draw attention to an additional problem raised by ratings, which concerns the lack of flexibility of the rating agencies in the case of an issuer's downgrade and its pro-cyclical herding behavior, particularly on the downside.

Recommendation 12: CRA supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds.

We support the view that the CRAs should

- Be transparent about their rating methodologies.

- Give reasonable time to funds for remedial actions in case of downgrades of specific instruments to avoid exacerbating the crisis by causing unnecessary fire sale effects.

- Should only take into account legally binding forms of sponsor or third-party support (e.g. letters of credit) in the attribution of ratings.

We also agree that regulators ensure that the reference to "Triple-A" ratings does not convey an importance of safety.

Recommendation 13: MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss.

We consider it is extremely important to put in place effective arrangements to ensure that MMF documentation inform investors that MMFs are not the same as bank deposits. They are an investment product, with associated investment risks. Investors in MMFs should clearly understand that they continue to bear the risks and rewards associated with the funds underlying investment portfolios and strategies. It should also be clear that the objective to preserve capital is not a capital guarantee.

Recommendation 14: MMFs' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.

EFAMA fully agrees with this recommendation.

Recommendation 15: When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by money market funds, taking into account the outcome of current work on repo markets.

In general, the conditions under which investment funds may engage in repo or securities lending in Europe are already partly covered by the UCITS Directive, supplemented in many European countries by additional rules applicable at national level. Furthermore, ESMA has recently adopted guidelines specifically covering repo and reverse repo arrangements when used by UCITS and has also published guidelines on UCITS criteria for the management of collateralized transactions.[3] We also draw the FSB's attention to our comments on the WS5 recommendations regarding securities lending and repos.

[3] EFAMA's response is available at the following web address: http://www.efama.org/Publications/Public/UCITS/12-4043_EFAMA%20reply%20ESMA%20consultation%20on%20the%20treatment%20of%20repo%20and%20reverse%20repo%20agreements.pdf

2. FSB Consultative Document "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

Preliminary remarks

EFAMA very much supports the targeted approach recommended by the FSB consisting in narrowing down its focus to the portion of the shadow banking system that can be defined as a system of credit intermediation that involves entities and activities outside the regular banking system, and raises systemic risk concerns and/or regulatory arbitrage concerns, while not inhibiting sustainable non-bank financing models that do not pose such risks

With this in mind, **EFAMA believes that the High-Level Policy Framework proposed by the FSB consisting in identifying possible shadow banking entities susceptible to raise significant systemic risks not by their legal forms or names but on the basis of economic functions or activities performed by these entities is the right approach**. As the Consultation Paper rightly points out, this framework will indeed provide financial regulators around the world with the flexibility needed to capture new structures or innovations that create shadow banking risks by looking through to the economic function and risks of these new innovative structures. At the same type, this approach based on economic functions rather than legal types of entities is also sufficiently granular to allow each regulator to assess which categories of entities should, in his jurisdiction, be categorized as "shadow banking entities" having due regard to all relevant circumstances prevailing in each jurisdiction (existing regulatory framework, local market practices, …) and to determine which policy tools are most suitable to reduce the systemic risks raised by these entities.

Having said that, **we have strong reservations with a number of examples provided in the Consultation Paper of possible entity types falling within each of the five economic functions identified by the FSB**. From a methodological point of view, the fact of providing examples in the Consultation Paper of entities (based on their legal type, such as "credit investment funds") engaging in those activities may be useful for illustrative purposes but appears to be in contradiction with the general approach proposed by WS3 following which competent authorities should define shadow banking entities on the basis of the economic functions they perform rather than on their legal type or names. By providing these examples, the risk is also to narrow the focus of the competent authorities on these examples only and therefore, to disregard or pay insufficient attention to other types of entities engaging in the same type of activities (for instance, why does the Consultation Paper refer to Exchange-Traded Funds and not to other types of Exchange-Traded Products, such as ETNs or ETCs, despite the fact that they perform the same economic function?).

More fundamentally, as already mentioned in our earlier submissions to the FSB and other international bodies, we are genuinely convinced that – because of the tight regulatory framework and strong supervision to which they are already subject or will be subject in a near future – European investment funds do not present significant systemic risks or opportunities for regulatory arbitrage and should therefore not be characterized as "shadow banking entities[4]. The experience during the global financial crisis confirms that net outflows from "credit investment" did not have any systemic consequence. One main reason for this is that the universe of these funds is very wide and fragmented, covering many different types of vehicles; hence, investors tend to react on a case by case rather than on a systemic basis. In general, investors are also aware that investment funds are investment products which entail a certain level of risk.

Lastly, we wish to draw the attention to the fact that many non-bank financial institutions – including in particular investment funds in most jurisdictions - are governed by long-established regulatory regimes which account for the specificities of their business models and indeed provide for adequate treatment of potential risks associated with shadow banking. The fact that those entities are not subject to the same type of prudential regulation as banks does not mean that they are unregulated or that the regulatory framework to which they are subject is less capable of preventing the occurrence of systemic risks. Far from it, it many respects, they are subject to an even tighter regulation than banks We therefore consider it extremely important that any regulatory measures deemed necessary for European investment funds should be consistent with the regulation already in place, in particular the UCITS and AIFM Directives.

Questions

Q1. Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?

Subject to the reservations expressed in our preliminary remarks (see above), EFAMA agrees that the high-level policy framework recommended by the FSB is the most suitable approach to capture and address shadow banking risks posed by non-financial entities in a comprehensive manner. Provided that the methodology recommended by the FSB is applied in a consistent manner across all financial sectors, this approach is in our view by far preferable to a categorization based on legal forms or market sectors.

We also believe that, in practice, it will be very important that the "policy toolkits" recommended by the FSB be applied in a manner that is proportionate to the level of risks incurred and subject to preliminary cost/benefits assessments in order to avoid unnecessary or inefficient regulatory measures, together with a specific attention to the already existing local regulation in order to avoid market disruptions. We therefore fully subscribe to the general principles for regulatory measures identified by the FSB (focus – proportionality – forward-looking and adaptable – effectiveness – assessment and review).

[4] For further details, please refer to the EFAMA reply to EU Commission Green Paper on Shadow Banking (http://www.efama.org/Publications/Public/EFAMA%20RESPONSE%20TO%20THE%20EUROPEAN%20COMMISSION%20GREEN%20PAPER%20ON%20SHADOW%20BANKING.pdf).

Concerning the risk of regulatory arbitrage, it will largely depend upon the effectiveness of the implementation of the proposed policy tools at national level. The risk of regulatory arbitrage will obviously be more prevalent in case of significant divergences in regulatory and/or supervisory standards among jurisdictions and also between different financial sectors. Against this background, we do believe that the effectiveness of the information-sharing process across jurisdictions will play an essential role in minimizing regulatory arbitrage opportunities.

Q2. Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).

EFAMA agrees that the five economic functions identified by the FSB, if they are effectively and consistently applied by the authorities across all financial sectors and jurisdictions, should adequately and comprehensively capture all non-bank financial activities that may pose significant shadow banking risks. Consequently, we do not believe that there are additional economic functions that authorities should consider, certainly as far as (European) investment funds are concerned.

As mentioned in our preliminary remarks, we disagree however with some of the examples provided by the FSB of entities supposedly engaged in one or several of these five economic functions. In this regard, we would like to make the following comments concerning functions 1 and 5 that are potentially relevant for investment funds:

- As regards the first economic function (*management of client cash pools with features that make them susceptible to runs*), we disagree with the assumption apparently being made on page 13 of the Consultation Paper that "real estate vehicles" belong to the shadow banking sector. In our view, there is no evidence that these funds raise systemic risk concerns and/or regulatory arbitrage concerns.

- More generally, we consider that "credit investment funds" which are properly regulated should not be considered as shadow bank entities, provided that the regulation concerned include a critical number of the policy measures recommended by the FSB, in particular limits on leverage, tools to manage liquidity risks, tools to manage redemption pressure in stressed market conditions, restrictions on eligible collateral.

- As regards the fifth economic function (*securitization and funding of financial entities*), the Consultation paper (page 10) puts the emphasis on ETFs (both physical and synthetic) which allegedly accept illiquid collateral from banks to cover counterparty risks involved in securities lending or derivative transactions. In this context, we wish to draw the attention of the FSB to the fact that in Europe the vast majority of ETFs are launched as UCITS and therefore are subject to the tight UCITS regulatory framework. Since July 2011, UCITS engaging in derivative transactions (including Total Return Swaps commonly used by synthetic ETFs) are required to accept only liquid collateral. In its recently adopted guidelines on UCITS ETFs and other UCITS issues, ESMA decided to extend this requirement to securities lending and repo transactions. These guidelines will become effective in February 2013 and prescribe the following in terms of liquidity of the collateral: "*Any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation*"[5]. It is therefore our understanding that the risk of liquidity transformation identified by the FSB with respect to ETFs may be seen as largely irrelevant for European ETFs (as well as all other UCITS).

Q3. Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Generally speaking, EFAMA considers that the suggested information listed in the Annex for assessing the extent of shadow banking risks is appropriate in capturing the shadow banking risk factors and we do not see additional items authorities could consider in this respect.

In terms of challenges related to the collection or provision of information to the supervisory authorities, we wish to underline that most European investment funds, be they UCITS or nationally regulated funds, already provide comprehensive information to the authorities, their investors and the wider public.

The AIFM Directive coming into force in July 2013 will bring the quality of supervisory monitoring to an even higher level by imposing ambitious reporting requirements on managers of alternative investment funds. Supervisory reporting will be mandatory for most AIFs on a quarterly basis and will include detailed information on portfolio composition, principal exposures and most important concentrations, risk profile and liquidity management. The AIFMD reporting will also provide helpful data for assessing the interconnectedness between banks and other financial entities. These requirements have been developed with the specific aim of enabling supervisory authorities to effectively monitor systemic risks associated with AIF management.

The AIFMD reporting requirements are unique in the EU financial sector as regards their frequency and effectiveness. Their implementation by mid 2013 will present a huge challenge for European fund managers, both in operational and financial terms.

Against this background, we deem it essential that any new reporting requirements stemming from the FSB recommendations on shadow banking be integrated into the existing reporting systems for investment funds and no separate reporting procedures be established for these purposes. As far as the AIFM regime is concerned, this should at the maximum prompt a refinement or possibly

[5] Article 43a) of the ESMA Guidelines on ETFs and other UCITS issues, officially published on 18 December 2012.

modification of the focal points of reporting with a clear view to avoiding excessive costs and operative burdens for the industry (which would ultimately have a negative impact on the returns for end investors).

Q4. Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

EFAMA is fully supportive of the overarching principles described in Section 3.1 of the Consultation Paper that the relevant authorities should apply to non-bank financial entities in all economic functions. Concerning Principle 3 (*Authorities should enhance disclosure by other shadow banking entities as necessary to help market participants understand the extent of shadow banking risks posed by such entities*), we would like to point out however that, although we support the objective of enhanced disclosures to market participants, we believe that in order to be effective the level of these disclosures should be proportionate to the materiality of the shadow banking risks but also to the needs and level of understanding of market participants. Too detailed or complex information may indeed become counterproductive in the sense that it could confuse investors or divert their focus from the information that are truly relevant from them to make well-informed investment decisions.

Subject to the remarks below, we also welcome the set of policy measures recommend by the FSB under Section 3.2 of the Consultation Paper, provided however that it is made absolutely clear that these measures can be applied selectively and proportionately (as opposed to automatically or in a rigid manner) by the relevant authorities to the shadow banking entities in their respective jurisdictions (depending on the already existing legal framework, for instance).

As far as investment funds are concerned, we wish to underline that many of the policy measures recommended by the FSB are already applicable to European investment funds, as explained below. Furthermore, we strongly believe that standards on liquidity risk measurement represent an appropriate approach to constraining potential systemic risk arising from “credit investment funds”. Such standards are currently being raised for alternative investment funds launched and marketed in Europe. Under AIFMD, fund managers shall be bound to maintain a level of liquidity in the fund portfolio which is appropriate to the fund’s underlying obligations and shall monitor the liquidity profile of the portfolio having regard to the contribution of individual assts and to the profile of the investor base. In addition, it is required that fund managers implement and maintain liquidity risk measurement procedures to assess the risk of positions and intended investments, and put into effect tools and arrangements necessary to manage the liquidity risk of each fund[6].

Regarding the specific tools proposed by the FSB, we have the following comments:

[6] Cf. Box 32 of ESMA’s technical advice on AIFMD implementation (ESMA/2011/379).

- **Tool 1 (Restrictions on maturity of portfolio assets):** maturity limits, if at all considered, should be strictly confined to funds bearing MMF-like features, especially short-term oriented, low risk investment strategies and reasonable expectation of low NAV volatility.

However, we would have strong reservation against the imposition of maturity limits to traditional bond funds, especially those investing in long-term loans. These vehicles do not compete with overnight bank deposits, but are explicitly marketed as investment products with dedicated investment horizons. Potential investors are informed in relevant fund documents that the performance of these funds are subject to fluctuations depending on market developments and that the proposed investment goals can be achieved only after a mid- to long-term holding period.

- **Tool 2 (Limits on leverage):** All European investment funds are either already subject to leverage limits or will be submitted to the supervisory authority's power to impose restrictions on the level of leverage once the AIFM Directive comes into force in July 2013[7]. For UCITS, there is a clear requirement that the global exposure obtained through the use of derivative instruments may not exceed the total net value of the fund portfolio[8]. Physical borrowing is generally forbidden except for temporary loans up to 10% of the fund assets[9].

- **Tool 3 (Tools to manage liquidity risk):** The UCITS Directive limits the potential for asset concentrations by imposing strict requirements on diversification of fund investments. Diversification must be ensured in terms of instruments, issuers and counterparties[10]. Moreover, European UCITS are in principle not allowed to invest in illiquid assets; only up to 10% of the fund value can be invested in transferable securities and money market instruments which are not admitted to trading on regulated markets[11]. As explained above, the AIFMD entry into force in July 2013 will significantly raise the regulatory standards of liquidity risk management for alternative investment funds.

- **Tool 4 (Managing redemption pressures in stressed market conditions):** Temporary suspension of unit redemptions is already allowed under the UCITS Directive to protect the interests of the fund investors in exceptional circumstances[12]. Suspensions can be decided upon by the fund manager or ordered by the competent authority if it is deemed in the interest of the unit holders or the public. Further measures for managing redemption pressures such as side pockets or gates are not yet very common in the European fund practice. Their authorisation is currently being discussed under the UCITS regime[13].

[7] Cf. Article 25(3) of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers (AIFMD).
[8] Article 51(3) of Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS Directive).
[9] Article 83(2)(a) of the UCITS Directive.
[10] Cf. Articles 52 to 56 of the UCITS Directive.
[11] Article 50(2)(a) of the UCITS Directive.
[12] Cf. Article 84(2) of the UCITS Directive.
[13] Cf. Consultation Document „Undertakings for Collective Investment in Transferable Securities (UCITS): Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments“ issued by the European Commission on 26 July 2012, Box 4.

Moreover, we support the possibility for investment funds to impose redemption fees as a tool for restraining redemptions. However, we believe that it would be disproportionate to require redemption fees which are applicable at all times. To prevent runs by fund investors in crisis situations, it should be sufficient to introduce trigger-based redemption fees. The relevant trigger should be dependent on factors which can hardly be anticipated by investors (e.g. level of liquidity in the fund portfolio) in order to avoid pre-emptive withdrawals of the invested money.

Q5. Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers to the extent possible.

As mentioned in our reply to question 3 above, the costs of having a separate reporting framework on matters that are relevant to shadow banking risks would clearly be excessive, in particular in light of the comprehensive reporting requirements already existing or currently being implemented for investment funds at EU level. Hence, we urge the FSB to recommend to its members the introduction of integrated reporting processes for the detection of systemic risks, including the risks associated with shadow banking.

3. FSB Consultative Document "A Policy Framework for addressing shadow banking risks in securities lending and repos

Preliminary remarks

EFFAMA supports the creation of a regulatory regime that increases transparency, protects investors while preserving consumer choice and assessing benefits versus implementation costs.

The recommendations cover three broad topics and multiple subjects within those topics. The three broad topics are: Transparency, Regulation, and Structural Aspects.

Transparency:

We support increased transparency so long as it provides information that is useful to regulators and to investors at a reasonable and sustainable cost. We support reporting to regulators but we believe the recommendations go beyond that and seek to mandate reporting that would be of little value to regulators or investors and at high cost to the industry to provide

Consequently, we believe that the required improved transparency (i) should be achieved on a position rather than transaction basis; (ii) reporting to the market, if deemed necessary, should be done on lagged and/or aggregate basis and (iii) report to leverage existing practices and conventions to minimise costs to regulators, to the market and ultimately to end-investors.

We would also like to remind to FSB that stock lending and repo markets provide important benefits in terms of liquidity and price discovery mechanism for the financial markets.

Lastly, EFAMA disagrees with the principle of imposing specific reporting requirements applicable only to fund managers.

Regulation:

Whilst we agree with the majority of the recommendations, especially that there should be broad "best practices" with regard to collateral and the collateralization process, we believe that the recommendations may unduly restrict the ability for market participants to make appropriate risk-based determinations regarding collateral.

Indeed, we consider that (i) minimum mandatory haircuts by way of principle could conflict with protecting client assets, i.e. there is a tension between bank supervision techniques and the asset manager's fiduciary duty and (ii) whilst we understand that lenders might face restriction in the asset acceptable as collateral, we trust that this requirement should not be too restrictive, as that would potentially increase risks by further concentrating risks at a time of stressed markets instead of ensuring sufficient diversification and liquidity.

<u>Structural Aspects</u>:

We agree with the conclusion reached by the FSB in its consultative document that (i) although encouraging the use of CCPs would be helpful to markets' stability, it might be too soon for less-standardized repos as well as for securities lending and (ii) changes to bankruptcy law should not be prioritized for further work at this time.

Questions

Q1. Does this consultative document, taken together with the earlier interim report, adequately identify the financial stability risks in the securities lending and repo markets? Are there additional financial stability risks in the securities lending and repo markets that the FSB should have addressed? If so, please identify any such risks, as well as any potential recommendation(s) for the FSB's consideration.

EFAMA considers that the consultative document, taken together with the earlier interim report, adequately and thoroughly captures the potential financial stability risks that could be generated by securities lending and repo activities. We are not aware of any other significant systemic risks that the FSB should address in relation to these activities.

We note, however that the financial stability risks identified by the FSB appear to be based primarily on a bank regulator's perspective, not a market regulator's and wish to point out that the fact that many entities engaging in securities lending or repo activities are not subject to the same type of prudential regulation as banks does not mean that they are unregulated or that the regulatory framework to which they are subject is less capable of preventing the occurrence of systemic risks..

Against this background, **we would like to stress 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 level** (notably through the UCITS Directive which sets limits on counterparty exposure, borrowing limits, ... and through the recently adopted ESMA guidelines on ETFs and other UCITS issues) supplemented in many EU Member States by extensive regulatory requirements at national level..

Indeed, fund management activities are governed by extensive sets of rules (at European Union's level, both UCITS and AIFM Directive) – which, importantly, may have the same economic effects as bank rules - requiring in any case proper authorization and supervision of the fund manager and in most instances, also authorization and marketing notification of each single investment fund, as well as requiring extensive disclosure of the funds' activities to investors and to the markets as a whole.

Recently, additional standards have been introduced by ESMA for all UCITS engaging in securities lending and repo transactions. Under the ESMA Guidelines, cash collateral received from securities lending can be placed on deposits, invested in high-quality government bonds, used for reverse repo transactions with regulated credit institutions or invested in short-term MMFs[14]. These restrictions on cash-collateral reinvestment effectively eliminate the risk of maturity and liquidity transformation challenged by WS5. Similarly, due to the requirement for non-cash collateral not to be sold, re-invested or pledged and to be held by the UCITS depositary in case of title transfer[15], re-hypothecation of assets received as collateral is generally excluded. The new ESMA Guidelines for UCITS 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[16].

In combination with the reporting duties to become mandatory in Europe in relation to securities lending and repos, we believe these measures applicable to European investment funds already address – or at least considerably mitigate – most potential financial stability risks identified by the FSB and could probably serve as a benchmark for other market participants engaged in these activities.

Lastly, whilst we understand that securities lending and repos are being perceived by theFSB as a possible source of systemic risk because of their potential to facilitate maturity/liquidity transformation and to contribute to the build-up of leverage, we also wish to underline the benefits that ancillary portfolio management techniques such as securities lending bring not only to the investors in our investment funds (additional revenues generated by the lending of securities enhance returns on their portfolio) but also to the markets (the availability of securities through securities lending translates into liquidity for the settlement of transactions). Therefore, in considering new regulations for securities lending or repos, regulators need to balance the benefits to the markets and to the investors with the need to mitigate risks.

Q2. Do the policy recommendations in the document adequately address the financial stability risk(s) identified? Are there alternative approaches to risk mitigation (including existing regulatory, industry, or other mitigants) that the FSB should consider to address such risks in the securities lending and repo markets? If so, please describe such mitigants and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?

EFAMA considers that, generally speaking, the policy recommendations contained in the consultative document adequately address the financial stability risks identified by the FSB. Given the global nature of securities lending and repo activities and the interest by regulators in multiple jurisdictions, we recommend an internationally coordinated approach to standards and regulation. EFAMA therefore very much welcome the work performed by the FSB in this area and is keen to continue assisting the FSB throughout this process.

It should be recognized, however, that some of the policy recommendations proposed by the FSB are far-reaching and will lead to significant changes to the established market practices but may also have unintended consequences as they appear to be based on a bank regulator's perspective and not

[14] Cf. Para 43 j) of the ESMA Guidelines on ETFs and other UCITS issues dated 17 December 2012 (ESMA/2012/832).
[15] Para. 43 g) and i) of the ESMA Guidelines on ETFs and other UCITS issues.
[16] Para. 43 b) of the ESMA Guidelines on ETFs and other UCITS issues.

that of a securities markets regulator. This pertains in particular to the minimum standards for methodologies to calculate haircuts (section 3.1.2) and the reporting requirements for fund managers if applied in an extensive manner (section 2.4).

In this context, EFAMA is more specifically concerned by the particular emphasis that the consultation document puts on investment funds while at the same time it disregards in some instances the risks posed by banks and regulated broker-dealers engaging in securities lending and repos (please refer to our subsequent remarks on Q16 and Q19). It is indeed our strong belief that, given the tight regulatory framework to which they are already subject in most jurisdictions (and certainly in Europe – see our answer to question 1 above), investments funds should not be the primary focus of regulators when it comes to potential systemic risks raised by securities lending or repo activities.

It is also important to consider that any policy recommendations which result from the consultation should apply to all participants in EPM techniques, i.e., to all lenders and all borrowers regardless of their regulatory form. By creating a consistent regulatory framework that would apply to all participants, the recommendations would force those poorly run programs to come up to market standard thereby benefiting all participants and the financial system as a whole.

Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe that would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment?

In general, EFAMA is more concerned about the opportunity of some of the policy recommendations, and by the costs their implementation would involve, rather than by the feasibility of their implementation

More specifically, we wish to highlight that the proposal to create a new "transaction repository" for the securities lending, repo, and reverse repo markets should is likely to impose significant costs on the industry (and ultimately on the end-investors) as well as on the regulators in charge of collecting the required data..

As an alternative, we believe that "position reporting" or "exposure reporting" would represent the best way to achieve greater transparency. Lenders and borrowers would each report their respective positions on a regular basis.

Position reporting would indeed (i) further make it easier for regulators to view related collateral positions; (ii) would allow leveraging off existing platforms used by the industry and (iii) would provide regulators with a robust view of the markets over time (for more details, please refer to .our answer to question 11)

We will also comment more specifically on the feasibility of implementing some of the policy recommendations in our answer to the detailed questions below.

Q4. Please address any costs and benefits, as well as unintended consequences from implementing the policy recommendations in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers, to the extent possible, that would assist the FSB in carrying out a subsequent quantitative impact assessment.

In terms of costs of implementation of the policy recommendations, **EFAMA is mainly concerned about the extensive reporting requirements proposed by the FSB which could potentially affect in a very detrimental way the returns for end-investors**.

In order to avoid unnecessary costs and administrative burdens on market participants resulting from these reporting requirements, EFAMA therefore urge the FSB to call upon competent authorities to leverage as much as possible on the already existing reporting processes to gather the data they need to adequately monitor systemic risks rather than creating new reporting tools or requirements specifically for that purpose. Indeed, If different reporting streams were to be implemented, this would probably have a negative impact transaction costs and would consequently reduce clients return

Similarly, the implementation of all reporting requirements should be coordinated in order to reduce this cost increase.

For the same reasons, we also believe that the final FSB report should call upon the authorities to evaluate their national regimes in the first place in order to assess whether and to what extent further regulatory measures are needed.

Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks)?

To the extent that operational processes must be changed, an appropriate phase-in period would allow for the industry to work with regulators to ensure that regulatory goals are achieved in a cost-effective manner. This may include leveraging existing processes and platforms which have already been built and are in use by major players in the industry around the world. To the extent additional processes or platforms must be built those would take a significant time to agree and to build as all participants in the securities lending, borrowing, repo, and reverse repo markets as well as regulators would need to design and build IT systems to link their systems together.

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 the final policy recommendations that will be adopted by the FSB.

2. TRANSPARENCY & DISCLOSURE

2.1 Improvement in regulatory reporting

Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items.

EFAMA agrees with the recommendation 1 that regulators need additional data on securities lending and repo exposures to provide them with a better understanding of the market's flows and inter-connections.

EFAMA would however like to remind that asset managers and regulated investment funds should not be considered as falling into this category of global systematically important banks adopted by the FSB Data Gaps Group. Asset managers are acting only as agents managing their clients' assets without dealing on own account or otherwise taking any risks on their trading books. Regulated investment funds, on the other hand, are generally bound by regulatory requirements on risk spreading and thus cannot take excessive risk in relation to one issuer or counterparty[17]. This significantly reduces the potential a fund's failure could have on other financial institutions.

In addition, European investment funds are already subject to extensive reporting duties regarding their engagements in securities financing or will be bound by such duties in near future.

We support the second recommendation which proposes that regulators should start by gathering limited information on a periodic basis whether through a survey process or through automated data feeds before requiring the implementation of reporting with specific datas. This initial effort will help regulators understand the information which is available, the sources from which it can be obtained, and the routine variation in balances, etc. After an evaluation period, evaluating the information which can be obtained through a periodic process, regulators may want to move to a more frequent or even daily process.

The ultimate goal is that any data gathering should be automated. We believe that existing means through which data are shared by participants in the securities lending and repo markets should be leveraged before considering the build up of new reporting systems.

[17] Under the UCITS Directive, for instance, the general limit to issuer risk is set at 5% of the fund assets (can be raised to 10%). Similarly, the risk exposure to one counterparty arising from OTC derivative transactions, securities lending or repos cannot exceed 10% of the fund assets. The combined maximum amount of investments in transferrable securities or money market instruments issued by an entity, deposits made with that entity and counterparty exposure to that entity cannot exceed 20% of the fund assets, cf. Article 52 para. 1 and 2 of Directive 2009/65/EC (UCITS Directive).

Generally, we believe that it would be advisable to take into account already existing locally reporting initiatives such as EMIR in Europe before deciding the definitive format and content of the reporting under discussion in this consultation.

Even though we do not believe that asset managers should be affected by the proposed reporting standards, we have the following comments regarding some specific data points listed in Box 1:

- Generally speaking, firstly, the notion of "securities available for lending" is missing a definition given that, potentially, all securities are available for lending.

- Secondly, Box 1 does not contain any specific reference to any specific treatment for triparty transactions such as triparty repos and triparty securities lending agreements.

2.2 Improvement in market transparency

Q7. Do you agree TRs would likely be the most effective way to collect comprehensive market data for securities lending and/or repos? What is the appropriate geographical and product scope of TRs in collecting such market data?

EFAMA believes that, compared to official surveys and regulatory reporting, TRs represent an effective way to collect data.

However, regulators should bear in mind the importance of (i) not imposing unnecessary additional costs on market participants that ultimately will impact returns for final investors and (ii) possible serious data cleansing issues unless regulators plan to obtain data from each participant in the market and perform the data matching.

Instead of a reporting based on transactions, we strongly recommend building a position reporting process whereby each participant reports their respective positions and regulators would see exposures as they change over time rather than specific transactions. Alternatively reporting obligations could also be structured in a way that it is to be reported immediately to the supervisory authority if the value of the collateral received by the Lender is below the value of the securities lent. As detailed above (please see our answer to Q6), both alternatives would have the benefit of leveraging existing platforms without significant additional resources required

Q8. What are the issues authorities should be mindful of when undertaking feasibility studies for the establishment of TRs for repo and/or securities lending markets?

EFAMA supports the need for further transparency including through the introduction of a TR.

However, we want to remind (i) the needs to set clear goal and clear requirements; (ii) no geographical loopholes or difference in treatment should be left, which could allow regulatory arbitrages and (iii) the cost and time to implement should be phased-in, e.g. in parallel to EMIR's implementation especially if contents can be unified.

Alignment and rationalisation of reporting are crucial and should be sought with (regulatory and central bank) authorities as many surveys are already in circulation, asking often very similar data.

EFAMA would also like to remind that securities lending and repos transactions are not one-time transactions but continuing contracts. This has implications for the construction of a TR as

- The principal(s) can change over the life of a trade; and
- The particular securities covered can change over the life of a trade in certain kinds of trades; and
- The collateral for a loan or repo can change over the life of a trade; and
- As the collateral changes the applicable haircuts can change over the life of a trade.
- Partial returns would need to be linked to the original transaction; and
- Stock splits or other corporate actions would need to be linked to the original transaction

Consequently, a single global TR, or a limited number of TRs would be preferable to multiple TRs for different jurisdictions or even different asset classes as it would then (i)be easier to send one data feed than multiple and (ii) increase data consistency.

2.3 Improvement in corporate disclosures

Q9. Do you agree that the enhanced disclosure items listed above would be useful for market participants and authorities? Would disclosing any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be disclosed instead.

EFAMA believes that fund managers should not be submitted to different reporting to the holders of the funds and to regulators.

A dual approach might be more appropriate. A set of more detailed elements might be shared with the regulators (including percentage of collateral pool re-used), whilst a more summarized format might be disclosed to the broader public.

2.4 Improvement in reporting by fund managers to end-investors

Q10. Do you agree that the reporting items listed above would be useful for investors? Would reporting any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be reported instead.

First and foremost, EFAMA does not understand why improvements to reporting to end-investors should apply only to fund managers. We would then be happy to engage into discussion with FSB to clarify or elaborate further on this latest part of this question 11.

Furthermore, EFAMA believes that the items listed under §2.4 are largely inappropriate for end-investors (and certainly for retail investors). E.g. Concentration data (Top 10 collateral securities received by issuer, top 10 counterparties of repo and securities lending (sources of borrowed cash, if applicable), and top 10 counterparties of reverse repo (sources of borrowed securities)) or, for funds investing in fixed income securities, the breakdown that would give the share of bonds (government bond, investment grade non-financial corporate bonds, sub-investment grade non-financial corporate bonds, investment grade financial corporate bonds, sub-investment grade financial corporate bonds, covered bonds, ABS, RMBS, CMBS etc.) are too granular data to be useful for end-investors.

The underlying assumption of these considerations is the finding that "securities lending and repos allow fund managers to access leverage on their clients' portfolios". This observation does certainly not apply to European regulated funds, especially retail funds such as UCITS.

In the securities lending market, UCITS are only allowed to act as lenders of securities with the corresponding counterparty risk being subject to strict collateralization requirements under the new ESMA guidelines.

The acceptable collateral may only be highly liquid, valued at least on a daily basis, of high credit quality and sufficiently diversified[18]. Moreover, non-cash collateral received by UCITS cannot be sold, re-invested or pledged and should be held by the depositary in case of a title transfer. Cash collateral may only be reinvested in high-quality government bonds or short-term MMFs[19]. ESMA appears determined to extend these restrictions to the treatment of proceeds from repos and reverse repos which would fully eliminate any risk of leverage associated with these transactions, notwithstanding the inconsistencies of this approach in legal and economic terms (cf. our comments on Q19 below)[20].

Hence, it is very clear that under the UCITS framework securities lending and repos cannot be used for building up leverage in the fund's portfolios. Moreover, the new ESMA guidelines for UCITS already introduce reporting requirements to investors in relation to the exposure obtained through securities lending and repo trades, the identity of counterparties, the type and amount of

[18] Cf. Para. 43 of the ESMA Guidelines on ETFs and other UCITS issues.
[19] Para. 43 g), i) and j) of the ESMA Guidelines on ETFs and other UCITS issues.
[20] This objective is quite clear from para. 42 of the ESMA Guidelines on ETFs and other UCITS issues.

collateral received by the UCITS and the revenues arising from these activities together with operational costs and fees incurred[21]. In our view, these reporting items are fully sufficient to account for the information needs of retail investors and must not be further enhanced or refined based on FSB's recommendations.

In this context, we have also serious doubts about the potential of fund reporting on securities lending or repos to be useful for dampening systemic risk and pro-cyclical effects associated with securities financing. Clearly, the details of reporting contemplated by WS5 are far too sophisticated for retail investors and cannot be reasonably expected to have any controlling impact on the retail markets. Professional fund investors may be interested in the suggested data and are certainly provided with it to some extent for the purpose of accounting or regulatory reporting. We do not believe that there is value to individual fund investors from disclosing the other items listed:

- The identity of counterparties
- Repo, reverse repo, and securities lending data breakdowns listed above;
- Re-use and re-hypothecation data;.
- Information on any restrictions on type of securities.
- Number of custodians and the amount of assets held by each.
- The way securities received by the counterparty are held;

3. Policy recommendations related to regulation

3.1 Minimum haircuts

Q11. Are the factors described in section 3.1.2 appropriate to capture all important considerations that should be taken into account in setting risk-based haircuts? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?

EFAMA is of the opinion that, in order to avoid procyclicality, haircuts levels should not be subject to reassessment and should remain stable.

It should not be overlooked that when regulating haircuts, one refers to risk of the third level: initial risk lies with the counterparty of the reverse repo, second level risk is in the quality of the securities received and third level relates to the collateral haircuts.

This remark prompts to a stable prudent and standardized approach to haircuts. Focus should be directed on the proper and regular valuation of securities received and their immediate legal availability in case of need.

As asset managers, we agree that a regulatory floor of 100% as applied to all participants in the securities lending, repo and reverse repo markets would be a beneficial "best practice," but we

[21] Para. 35 of the ESMA Guidelines on ETFs and other UCITS issues.

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 a robust daily mark-to-market process using independently-established valuation as suggested in Recommendation 11 than from requiring a minimum haircut without robust processes.

We also fear that the suggested factors to be taken into account for setting risk-based haircuts might be very ambitious. Especially, it would be very difficult to capture all the other risk considerations and specific characteristics of the collateral as proposed in subsection (ii) as the calculation methodologies for haircuts are generally based on the historical or simulated volatility of assets.

12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?

EFAMA believes that the main benefit of numerical floors for haircuts, would be de-facto initial margin. This should subsequently reduce the amount of upfront funds lent against specific collateral. Several EFAMA members would suggest avoiding a minimum haircut for government bonds (please see our answer to question 15 and 16).

The fact that the proposed schedule does not refer to any rating is positive to reduce overreliance on rating agencies. On the other hand, it limits the possibilities to develop a better granularity and accept lower haircuts on better assets.

Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

EFAMA believes that it is not possible to express a view without taking into account the scope of the numerical haircut framework: for some entities or activities one or the other of the two options or a full exemption (see footnote 13 on page 16 concerning securities lending and cash collateral) might be better adapted.

In principle, we do not object to WS5's recommendation to introduce numerical floors on haircuts for securities financing transactions (subject to our replies to questions 11 and 12). We also agree with the assessment that bonds, securitised products and equities display material procyclicality risk and therefore should be captured by the numerical framework. The same should be true for investment funds focusing on investments in these types of assets.

Furthermore, we concur with the view that the proposed numerical haircuts should be considered a floor framework and be set at a level below the prudent market standards for actual haircuts in normal circumstances.

Therefore, we have a clear preference for option 2 (backstop level) as it leaves market participants more flexibility to apply higher haircuts based on their own analysis.

Option 1, in contrast, runs the risk of becoming an effective market standard due to its alignment with the actual market practice. As a consequence, option 1 might prompt market participants to automatically apply the minimum haircuts without conducting proper assessment of collateral risks. Moreover, option 1 can unduly increase the costs of securities financing if the risks of certain assets diminishes due to changes in market conditions.

Q14. Are there additional factors that should be considered in setting numerical haircut floors as set out in section 3.1.3?

In our opinion, the most important characteristics of assets eligible as collateral are liquidity and proper up-to-date valuation. Asset classes featuring high liquidity and subject to reliable valuation should be assigned comparatively low minimum haircuts. For the more illiquid collateral buckets, we would think current market haircuts should suffice.

On this basis, significantly lower haircuts than suggested by WS5 should apply to equities. The market experience has shown that equities are by far the most liquid instruments with effective pricing which can be easily sold even in crisis situations. On the other hand, sovereign bonds display comparably low liquidity which should be adequately reflected in the applicable numerical floor.

Q15. In your view, how would the numerical haircut framework interact with model-based haircut practices? Also, how would the framework complement the minimum standards for haircut methodologies proposed in section 3.1.2?

The reference (page 14) to the schedule proposed by the BCBS-IOSCO working group on margining requirements (WGMR) for non-centrally cleared derivatives and to Basel 3 requirements is important as consistency throughout different regulations is essential for market participants.

EFAMA suggests that a two level approach should be considered.

On one hand, the proposed schedule should be considered as an absolute minimum below the prudent market standards, and on the other hand it should be possible to overrule it by reference to a model approach based on models approved by the concerned regulator.

This two way approach would offer flexibility (subject to approval). However when a model has been agreed upon by one regulator it should be eligible for its counterparties, even if they are regulated by another authority.

Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

EFAMA supports WS5 analysis that only transactions aiming at refinancing and developing high leverage should be subject to haircuts numerical floors and that cash collateralized securities lending should be left out of scope. Note however that, as soon as they participate to a refinancing transaction that would bring leverage, collateral swaps should also be subject to floors.

Some members are of the opinion that introducing minimal regulatory haircut on sovereign bonds is effectively relevant but raises many questions as it refers to state sovereignty and to currency supervision, two key political issues, especially in the framework of a currency union with a single central bank as the Eurozone (please see also our ansquer to Q12).

The notion of risk free interest rate only seems to apply to the best (one or a small number of homogenous countries) of all countries constituting the zone; all other sovereign bonds present a spread.
It appears not justified to exclude sovereign bond collateral from the numerical haircut requirements. As already explained sovereign bonds feature rather low liquidity and hence should be subject to appropriate haircuts if accepted as collateral. Moreover, in the current market environment it cannot be seriously claimed that sovereign bonds display no default risk or are generally not prone to procyclicality.

The suggestion of those members is that sovereign bonds would not be included in the scope of standard regulatory haircuts but should be accepted with the same rules as applied by the central bank which accepts them for refinancing. Procyclicality would hence be in the hands of the central bank and there would not be room for regulatory arbitrage.

To the contrary, EFAMA does not share the analysis conducted on the counterparties as it only divides the world in two sides: prudentially regulated financial entities and other entities. Transactions with non regulated or quasi-non regulated entities should be the priority for the application of numerical floors.

That last part cannot be considered globally without taking into consideration the level of risk they may generate. It is essential that counterparties are analysed according to both the degree of regulation and supervision they are subject to and the level of leverage they are allowed to reach.

Additionally, we do not see any proper reason to limit the application of the proposed standards depending on the counterparty type. Arguably, if securities lending and repos are considered "bank-like" activities due to their potential to create money-like liabilities, carry out maturity/liquidity transformation and obtain leverage[22], then the negative implication of such activities for the financial stability should be tackled for all market participants. In particular, it appears unacceptable to exclude the biggest actors in the securities lending and repo markets such as banks or broker-dealers from the scope of the numerical floor regime. Such limited application might tamper the effectiveness of the entire policy framework for combating systemic risk and must be expected to negatively impact the competitiveness of securities lending and repo transactions for other market participants.

In this context, it must be recognised that "direct appropriate regulation of liquidity and leverage" pertains not only to banks and broker-dealers. Regulated investment funds such as UCITS and other types of mutual funds are subject to even more granular rules on liquidity and leverage which are relevant for the composition of individual portfolios.

Therefore, we are generally in favour of implementing numerical haircut floors via market-wide regulation as envisaged by WS5 in option 2 on page 19. This approach is clearly the best choice in terms of effective regulation as it would subject any entity engaging in securities financing transactions to the same requirements.
Should the FSB decide to exempt "regulated financial intermediaries" from the new standards for haircuts, we request to widen the scope of such exemption to include regulated investment funds and fund managers acting on their behalf.

Q17. Are there specific transactions or instruments for which the application of the numerical haircut floor framework may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.

EFAMA does not perceive any major practical difficulties in this regard. We would however remind that considering the framework for regulated funds, they should remain outside the scope of the regulation.

Secondly, the use by governments of a variety of issues, from pledging margin to hedging tools could be a problem. The settlement of government bonds is often extended. This is done frequently to bridge settlement timing gaps and cash flow gaps against purchases and sales of corporate and MBS positions that normally have settlement dates other than the standard T+1. Considering these extensions in settlement, it is impossible to haircut a settlement date that has been extended. On a large scale, applying haircuts to these securities will make it operationally more difficult and increase failures in the system.

[22] Cf. Section 1.2.5 on page 11 of the FSB Consultative Document „Strengthening Oversight and Regulation of Shadow Banking: An Integrated Overview of Policy Recommendations" dd. 18 November 2012.

Q18. In your view, how should the framework be applied to transactions for which margins are set at the portfolio basis rather than an individual security basis?

EFAMA would like to remind that margins are counterparty credit risk mitigation tools and are set and exchanged at client's level.

From an asset management's perspective, this exchange of margins at client's level is set at the portfolio level and it is not possible to ask for any other approach. In the market practice, margin and haircut requirements apply mostly on the portfolio basis. Most market participants use baskets of assets which can be chosen by the counterparty as collateral. This practice also provides for netting opportunities in case of opposing transactions.

In that respect the use of models is common practice and should be encouraged. The numerical floors framework can be only one of two ways: regulatory minimum or internal model.

3.2 Cash collateral reinvestment

Q19. Do you agree with the proposed minimum standards for the reinvestment of cash collateral by securities lenders, given the policy objective of limiting the liquidity and leverage risks? Are there any important considerations that the FSB should take into account?

EFAMA broadly agrees with the idea expressed by WS5 that the minimum standards for cash collateral reinvestment "should apply to all financial entities that are engaged, with or without an agent, in securities lending against cash collateral where the cash collateral is reinvested in a portfolio of assets". As with other aspects of the Recommendations, we support the establishment of "best practices" which should apply to all participants in the market and not only those which are already highly regulated. We believe the Recommendations make reasonable, common-sense suggestions for consistent regulatory action that would still permit Lenders to make reasonable determinations regarding how their cash collateral is invested. A fund should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.

We consider that non-cash collateral should not be sold, re-invested or pledged. Cash collateral should only be placed on deposit, invested in high-quality government bonds, used for the purpose of repo or reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the investor is able to recall at any time the full amount of cash on accrued basis or invested in short-term money market funds. Re-invested cash collateral should be diversified with a limit of 20% per issuer (please see also our answer to Q10).

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 of time. Repos can be concluded in one deed or by means of two separate buy and sell-back agreements where the nature of the transaction as a genuine purchase contract becomes even more evident. 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 mostly the purpose of generating additional profits for the fund from the lending fees or interests on cash collateral and facilitating settlement.

Therefore, it would be very helpful if the FSB could endorse in its final policy recommendations that the principles for cash collateral reinvestment have no impact for cash obtained from repo transactions.

Otherwise, this would *de facto* eliminate 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. This could consequently counteract the G20 objective of extending the central clearing of derivatives and raise insolvency risks which could be avoided in the CCP model.

3.3 Requirement on re-hypothecation

Q20. Do you agree with the principles set out in Recommendation 9?

EFAMA supports the FSB's efforts to enhance and streamline the global regulatory standards in this regard.

We agree with the proposed definitions (p. 22) that asset managers of UCITS funds are not in a position to re-hypothecate and are only concerned with re-use of securities. Indeed, they do not hold assets of their clients but manage portfolios in the best interest of the holders of the funds.

We also support the Recommendations' reasonable restrictions on the purposes for which client assets can be re-used. Nevertheless portfolio managers should retain the possibility to authorize counterparties to re-hypothecate their assets in some well-defined circumstances, as it may reduce cost of some transactions and be in the best interest of holders. "No re-hypothecation without our prior consent" should be the rule.

3.4 Minimum regulatory standards for collateral valuation and management

Q21. Do you agree with the proposed minimum standards for valuation and management of collaterals by securities lending and repo market participants? Are there any additional recommendations the FSB should consider?

As mentioned above (see Q10 above), we strongly support the recommendation of daily mark to market and the collection of variation margin for exposure to counterparties. We believe that this requirement would be a greater improvement to existing processes than a minimum haircut requirement. Access to securities received as collateral very much depends on applicable security and bankruptcy laws. A specific effort to improve securities law, in order to make it impossible to have more certificates in circulation than shares issued, should be on the agenda of FSB.

Minimum standards for valuation of collateral would be a positive step as it would greatly increase transparency in the market. If there were guidelines and processes to follow in times of a repo counterparty failure, this would also decrease pressures in the market.

Additionally, the requirement that “securities lending and repo market participants should only take collateral types that they are able following a counterparty failure to hold outright without breaching laws or regulations” (section 3.4 para. 1) should not imply an obligation for investment funds to accept only collateral compliant with their investment policy as defined in the fund rules or instruments of incorporation.

As a consequence, regulatory measures for investment funds focus in the first place at ensuring that the received collateral is of good credit quality, highly liquid and subject to frequent valuation in order to warrant the possibility of smooth disposal following the counterparty’s insolvency. This approach has been recently endorsed by ESMA in its Guidelines for ETFs and other UCITS issues[23].

4. Policy recommendations related to structural aspects of the securities financing markets

4.1 Central clearing

4.2 Changes to bankruptcy law treatment of repo and securities lending transactions

Q22. Do you agree with the policy recommendations on structural aspects of securities financing markets as described in sections 4.1 and 4.2 above?

We agree with the WS5’s conclusions as to the lack of a pressing need for regulatory or other action regarding the discussed structural aspects of the securities lending and repo markets.

The regulatory standards proposed for central clearing of OTC derivative trades under regulations such as EMIR seem appropriate as CCPs are supposed to clear deals that are standardized and liquid. The provisions of EMIR for mandatory central clearing include an assessment of these two criteria by ESMA, on top of the examination conducted in the process of authorization given by the local regulator to clear a new contract. That principle applies to derivative instruments and could also apply to repos and securities lending transactions subject to a thorough evaluation of potential market impacts.

[23] In the preceding consultation ESMA has considered requiring a high level of correlation between the collateral and the fund investment policy, but has refrained from this step following the feedback received from market participants, cf. para. 42 and 43 of the Feedback Statement published in the ESMA Report and Consulation paper dated 25 July 2012 (ESMA/2012/474).

In this regard, EFAMA also fully supports the envisaged evaluation of the costs and benefits of introducing central clearing of transactions. Such evaluation should take into account the current obstacles for market participants to obtain direct access to CCPs. Fund managers are generally not able to become direct CCP clearing members because they do not hold the necessary trading licenses. Hence, they need to approach a CCP indirectly by signing clearing agreements with direct clearing members, usually brokers who can provide such services. This intermediation increases clearing costs for fund investors and adds to the complexity of transactions in already strictly regulated products.

As regards the contemplated changes to bankruptcy law treatment of securities lending and repo transactions, safety of repos and securities lending is essential and any envisaged modification to existing rules should be subject to extended consultation and worldwide impact assessment. There is however no need to rush into changing bankruptcy laws.

However, we believe that this question should be left for further analysis and we would recommend postponing any proposed global alignment in the bankruptcy law or even declaring such changes “viable theoretical options” as proposed by WS5.

Brussels, 14 January 2013
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