The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 26711

November 21, 2012

FSB Requests Comment On Their Proposed Policy Framework To Address Shadow Banking Risks In Securities Lending and Repos

[26711]

November 21, 2012

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 47-12
ICI GLOBAL SECURITIES LENDING & REPO TASK FORCE No. 3-12
INTERNATIONAL COMMITTEE No. 44-12
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 57-12
SEC RULES COMMITTEE No. 76-12 RE: FSB REQUESTS COMMENT ON THEIR PROPOSED POLICY FRAMEWORK TO ADDRESS SHADOW BANKING RISKS IN SECURITIES LENDING AND REPOS

As the next step in its process to develop policy recommendations to strengthen the regulation of securities lending and repos, [1] the Financial Stability Board (FSB) has published a Consultative Document that contains policy recommendations to: improve the transparency associated with securities lending and repos; regulate securities financing; and address structural aspects of the securities financing markets. [2] The FSB has requested comment on its recommendations, which are summarized below, by January 14, 2013.

The Institute plans to file a comment letter on the FSB's proposal. If you are interested in providing input to the Institute on its letter, please contact either Bob Grohowski (at rcg@ici.org or 202-371-5430) or Tami Salmon (at tamara@ici.org, 202-326-5825) no later than Tuesday, November 27th. The Institute will convene a conference call of members interested in participating in this initiative shortly thereafter to discuss the contents of our comment letter.

Summary of the FSB's Thirteen Recommendations

Annex 1 to the FSB's Consultative Document summarizes the thirteen recommendations on which the FSB seeks comment. The Consultative Document discusses each recommendation in more detail, including the basis for the recommendation, alternatives considered, and specific questions on which the FSB seeks comment. The FSB's thirteen recommendations and some of the specific questions on which they seek comment are set forth below.

Recommendation 1: Data Collection

Regulatory authorities should collect more granular data on securities lending and repo exposures amongst large financial institutions [3] and should leverage existing international initiatives such as the FSB Data Gaps Group. [4]

Recommendation 2: Creation of Trade Repositories ("TRs")

Because TRs are likely to be the most effective way to collect comprehensive market data on securities lending and repos, the FSB should consult on the appropriate geographical and product scope of such TRs and encourage national/regional authorities to undertake the feasibility studies to establish TRs. The FSB should also undertake, and involve market participants in, a feasibility study for one or more TRs at a global level. [5]

Recommendation 3: Interim Data Collection Step

As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.

Recommendation 4: Improve Public Disclosure Regarding Securities Lending/Repo Activities

The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions' securities lending, repo, and collateral management activities, as needed. Pages 9-10 of the Consultative Document lists some of the enhanced disclosure matters being considered [6] and seeks input on whether the listed items would be useful for market participants and authorities and whether disclosure of some items might present significant practical problems.

Recommendation 5: Providing End Investors More Information

Authorities should review reporting requirements for fund managers to end investors to provide end investors information necessary to select their investments with due consideration of the risk taken by fund managers. Pages 10-11 of the Consultative Document list the types of data that might be provided to end investors as global data, concentration data, repo and securities lending and reverse repo data breakdowns, reuse and re-hypothecation data, return data, number of custodians and the amount of assets held by each, and whether securities received by the counterparty are held in segregated or pooled accounts. Q10 of the Consultative Document seeks input on whether such information would be useful for investors and whether any items of the information would present significant practical problems.

Recommendation 6: Collateral Haircut Methodologies

Authorities should introduce minimum standards for the methodologies firms use to calculate haircuts on collateral and such standards should seek to minimize the extent to which the methodologies are pro-cyclical. Also, standard setters should review their existing requirements for the calculation of collateral haircuts. Among other things, the Consultative Document recommends that:

- Haircuts be based on the long-run risk of the assets used as collateral and be

calibrated at a high confidence level (e.g., 95th percentile, one-tailed confidence interval) to cover potential declines in collateral values during liquidation;
- Haircuts be calculated either on a transaction-level basis or at the collateral portfolio level depending on individual circumstances;
- Haircuts not be based on a rolling short window (e.g., two years or less) of recent price data – instead they should be calculated using at least one stress period;
- Where available, historical bid-ask spreads and pricing uncertainty should be examined to consider that stressed market conditions may lead to a widening of such spreads;
- The assumed liquidation bid-ask spreads: be conservative, reflect the expected liquidity of the asset in stressed market conditions, and depend on the relevant market characteristics of the collateral (e.g., trading volume and market depth);
- Haircuts capture other risk considerations where relevant (i.e., in addition to reflecting the risk of fluctuations in the collateral price, they should take into account considerations such as the risk of liquidating large concentrated position and “the wrong-way risk” between collateral value and counterparty default);
- Haircuts should take into account specific characteristics of the collateral including asset type, issuer creditworthiness, residual maturity, price sensitivity (such as modified duration), optionality, complexity of structure, expected liquidity in stressed periods, and the frequency of collateral valuation and margining;
- Where applicable, the haircut should take into account foreign exchange; and
- Haircuts should take into account the potential correlation between the value of the collateral asset and the default of the counterparty as well between securities accepted as securities loaned in securities lending transactions.

The FSB seeks comment on whether the above list of factors: (1) is appropriate to capture all of the important considerations that should be taken into account in setting risk-based haircuts; (2) omits to include other important considerations that should be includes; (3) are aligned with current market practices; and (4) would impose practical difficulties if imposed on certain transactions or instruments. The FSB is also interested in knowing how the framework should be applied to transactions for which margins are set at the portfolio basis rather than on an individual security basis.

Recommendation 7: Numerical Floors for Haircuts to Address Procyclicality Risks

The FSB should consider introducing a framework of numerical floors on haircuts where there is material procyclicality risk. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets and consider whether numerical floors would be effective and workable, including their application to counterparties, collateral, and transaction type. The Consultative Document discusses two approaches to numerical floors: (1) a “High Level” approach in which the floors are set at relatively high levels that may typically be closer to actual market practices in normal times; and (2) a “Back-stop Level,” which would set the floor framework at a level below the haircuts that would be used by a prudent market participant in normal times, but above the level to which haircuts declined at the height of the 2000s boom. [7]   The Consultative Document seeks comment on what would be the main potential benefits, the likely impact on market activities, and possible unintended consequences of this recommendation and how it would complement the minimum standards for haircut methodologies discussed in Recommendation 6. [8]

Recommendation 8: Use of Securities Lending by Non-Banks

Regulators of non-banks that engage in securities lending (including securities lenders and their agents) should implement minimum regulatory standards for cash collateral investment to limit liquidity risks. The FSB seeks comment on the appropriateness of imposing such minimum standards to limit liquidity and leverage risks and whether there are any important considerations the FSB should take into account relating to this issue.

Recommendation 9: Rehypothecation

Regulations governing rehypothecation should ensure that: (1) financial intermediaries provide sufficient disclosure to clients so clients can understand their exposures; (2) there are limits on an intermediary's ability to rehypothecate clients' assets to finance their own long positions or cover short positions; and (3) only entities subject to adequate regulation of liquidity risks are allowed to rehypothecate clients' assets. The Consultative Document asks whether commenters agree with these principles relating to rehypothecation.

Recommendation 10: Review of Client Asset Rules and Rehypothecation

An appropriate expert group on client asset protection should examine possible harmonization of client asset rules with respect to rehypothecation, taking into account the systemic risk implications of the legal, operational, and economic character of rehypothecation.

Recommendation 11: Collateral Valuation and Management

Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants. The FSB is interested in knowing whether commenters agree with this recommendation and whether there are additional recommendations it should consider.

Recommendation 12: Cost/Benefit Implications of Introducing Central Counterparties (CCPs)

Authorities should evaluate the costs and benefits of proposals to introduce CCPs in the securities lending and repo markets, particularly where important funding providers in the repo market are currently not participating in existing CCPs

Recommendation 13: Delay Consideration of Revisions to the Bankruptcy Law

Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) should not be prioritized for further work at this time due to significant difficulties in implementation.

Additional Issues on which the FSB seeks Feedback

In addition to the input requested on each of the recommendations discussed above, the FSB seeks input on the following five issues: [9]

1. Whether the Consultative Document adequately identifies the financial stability risks in the securities lending and repo markets. Are there additional risks they should have addressed? If so, what are they and what are potential recommendations the FSB should consider to address them?

2. Whether the recommendations in the Consultative 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 risk in the securities lending and repo markets? If so, what are they, how do they address risks, and are they likely to be adequate during times of extreme financial stress?

3. The feasibility of implementing the policy recommendation or any alternatives in the jurisdictions.
4. The costs and benefits – including any unintended consequences – from implementing the recommendations in the jurisdictions. To the extent possible, the FSB request that commenters provide it quantitative information that would assist it in carrying out a subsequent quantitative impact assessment.
5. An appropriate phase-in period to implement the policy recommendations.

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endnotes

[1] As you may recall, in May 2012, the FSB published a report from its workstream on securities lending and repurchase agreements that identified a number of issues that, in the FRB's view, might pose risks to financial stability. See Institute Memorandum No. 26121, dated May 14, 2012, which summarized the FSB's proposal. The Institute was one of seventeen persons that filed a comment letter with the FSB on its report. See Institute Memorandum No. 26196, dated May 29, 2012, which summarized the ICI's comment letter.

[2] See Consultative Document, Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Financial Stability Board (18 November 2012) ("Consultative Document"), which is available at: http://www.financialstabilityboard.org/publications/r_121118b.pdf.

[3] Box 1 on pp. 5-7 of the Consultative Document lists the proposed information items that might be collected as part of the data collection initiative to improve market transparency. Q6 on page 9 of the Consultative Document seeks input on the items listed in Box 1, including whether they would enhance transparency, are already publicly available, or would present significant practical problems.

[4] According to the Consultative Document, the FSB Data Gaps Group "is aiming to provide a consistent framework to pool and share relevant data on the major bilateral linkages between large international financial institutions, and on their common exposures to and funding dependencies on countries, sectors, and financial institutions." Consultative Document at p 5.

[5] Box 2 on p. 8 lists three alternative ways to collect the data. Q7 on p. 9 of the Consultative Document questions whether the TRs would be the most effective way to collect comprehensive market data and seeks input on the appropriate geographical and product scope of TRs in collecting such market data. Q8 seeks input on the issues authorities should be mindful of when undertaking feasibility studies for the establishment of TRs for repo and/or securities lending markets.

[6] The matters listed are: counterparty concentration; maturity breakdown of trades; composition of securities lent, borrowed, reversed in, and repo-ed out; composition of collateral received against securities lent; information on collateral margins; percentage of collateral pool reused, broken down by client v. own activity; breakdown of activity done for own account and on behalf of customers; amount of indemnification provided as agent to securities lending clients and maturity profile of those contingent liabilities where applicable; and credit risk exposure broken down by securities lend, securities borrowed, repo, and reverse repo.

[7] Pages 14 and 15 of the Consultative Document include charts displaying two options (Option 1 (High Level) and Option 2 (Back-stop)) of "Numerical floors for securities-against-cash transactions," which correlate the haircut levels for sovereign products, corporate and other issuers, and securitized products to the residual maturity of the collateral. The FSB seeks input on whether Option 1 or Option 2 would be more effective in reducing procyclicality and limiting the buildup of excessive leverage while preserving liquid and well-functioning markets.

[8] It also seeks comment on whether the framework should be applied based on transaction type, counterparty type, or collateral type and which would be most effective in reducing procyclicality risks associated with securities lending while preserving liquid and well-functioning markets.

[9] See Consultative Document at p. 2.