

COMMENT LETTER

November 27, 2013

ICI and ICI Global Submit Comment Letter to the FSB on Securities Lending and Repo Haircuts (pdf)

November 27, 2013 Secretariat of the Financial Stability Board c/o Bank for International Settlements CH-4002 Basel, Switzerland Re: Proposed Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions (Annex 2 of August 29, 2013 Report on Strengthening Oversight and Regulation of Shadow Banking) Dear Sir or Madam: The Investment Company Institute¹ and ICI Global² appreciate the opportunity to comment on the Financial Stability Board's proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions (the "Margin Consultation").³ Given the extent of their participation in the securities lending and repo markets, investment funds worldwide have a strong interest in the FSB's recommendations in this area.⁴ Although we commend the FSB for seeking to identify and address systemic risk concerns in securities lending and repo markets, we continue to have serious reservations about the FSB's recommendations relating to margin haircuts. In our view, the FSB's focus on haircuts is misplaced and its recommendations inappropriately dictate terms best left to the parties to negotiate.

1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$15.7 trillion and serve over 90 million shareholders.

2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US \$1 trillion.

3 Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (August 29, 2013), available at http://www.financialstabilityboard.org/publications/r_130829b.pdf.

4 ICI and ICI Global have submitted a number of comment letters to the FSB in connection with its consultations on securities lending and repo markets. Appendix A contains a list of our comment letters to date.

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Our specific comments on the Margin Consultation follow. Preliminarily, however, there is one aspect of the FSB's final recommendations that warrants comment from our perspective. We were disappointed that the FSB chose to include in its policy recommendations a section on fund manager disclosure to end investors, adopted word-for-word from the FSB's 2012 consultation.⁵ While we support transparency, we are troubled that the serious concerns we expressed over this recommendation were not addressed in

any way. We continue to believe that it is inappropriate for the FSB to single out fund managers for a discussion on the appropriateness of their investor disclosures, particularly given that the FSB does not attempt to draw any link to financial stability concerns in this context. Fund managers are but one type of securities lender or repo counterparty, along with pension funds, insurance companies, and others. And, more broadly, registered funds are but one of a number of financial firms involved in these markets, and not necessarily the most important when thinking about transparency and systemic risk issues.⁶ The FSB offered no systemic risk justification for uniquely addressing disclosure by fund managers in its 2012 consultation, and offers none now in its final policy recommendations. Frankly, we cannot discern any reason why the FSB should single out fund managers in this regard. Moreover, substantively, the disclosure suggested by the FSB may well be excessive for many registered funds that engage in only a limited amount of securities lending or repo. The substance, frequency, and amount of disclosure on any given topic should be commensurate with the materiality of that information to investors; the extent of fund disclosure on an investment strategy should be reasonably related to the importance of that strategy to the overall risks and returns of the fund.⁷ In jurisdictions such as the U.S., where there are regulatory limits on the extent of a registered fund's participation in securities lending or repo, such extensive disclosure may be clutter—it may simply serve to obscure far more relevant risk disclosures. While we wholeheartedly agree that fund managers should be required to disclose information necessary to allow investors to select investments with due consideration of the risks taken by the fund, the FSB's sweeping recommendation in this area demonstrates precisely why policy decisions about the contours of that disclosure should be left to the appropriate national regulator's discretion to determine.

5 Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, FSB Consultative Document (November 18, 2012), which is available at https://www.financialstabilityboard.org/publications/r_121118b.pdf.

6 For example, the U.S. Congress recently addressed securities lending transparency by focusing on securities borrowers and lenders, rather than fund shareholders. See Section 984 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

7 See, e.g., Registration Form Used by Open-End Management Investment Companies, SEC Release No. IC-23064 (Mar. 13, 1998), available at <http://www.sec.gov/rules/final/33-7512r.htm> (directing U.S. mutual funds, whenever possible, to “avoid a disproportionate emphasis on possible investments or activities of the fund that are not a significant part of the fund's investment operations”).

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Comments on the Margin Consultation Our comments on the Margin Consultation focus on two sections: Section 2, which sets forth minimum standards for methodologies used to calculate haircuts, and Section 4, which proposes specific numerical floors for haircuts.

Section 2: Haircut Methodologies Section 2 of the Margin Consultation sets forth a number of recommendations for methodologies used to calculate risk-based haircuts that appear intended to apply to both securities lending and repo transactions. For the reasons below, we do not believe that they should be adopted for either securities lending or repo transactions. The FSB's Recommendations Will Not Prevent the Build-Up of Excessive Leverage. The Margin Consultation assumes a direct relationship between the size of haircuts for repos and securities lending transactions and the amount of leverage in the financial system. This is a flawed assumption. Even looking at repos and securities lending in a vacuum, any decrease in leverage that results from an increase in haircuts would be insignificant. For example, suppose a broker-dealer has \$102 million of general collateral available for repo transactions. At a standard haircut of 2%, the broker-dealer could raise \$100 million through repos using this collateral. If the haircut were increased to 4%, the broker-dealer could still raise \$98.077 million. Thus, doubling the haircut on repos would

result in less than a 2% reduction in the broker-dealer's leverage. Moreover, the assumption ignores the fact that repos and securities lending cannot be viewed in a vacuum. Firms may obtain credit in a variety of ways, including by obtaining secured and unsecured bank loans, selling assets to asset-back securities conduits, issuing bonds and commercial paper, as well as entering into repos and engaging in securities lending. Instead of reducing the amount of leverage in the financial system, requiring less favorable terms for one form of credit may simply force firms to obtain credit in other ways. Any reduction in repos and securities lending likely will be offset by increases in other, cheaper forms of credit.

Changes in Margin Haircuts Have Not Been Pro-Cyclical. Our comments on the 2012 consultation provided evidence that neither securities lending nor repurchase agreements have been subject to pro-cyclical variations in margin haircuts. The current consultation fails to respond to this evidence. We continue to believe that standard practices regarding margin haircuts are not pro-cyclical, and that, rather than decreasing the risks of procyclicality, the proposed methodology may increase the risk of credit disruptions. With respect to securities lending transactions, haircuts are not typically set on a variable, risk-based basis. In the U.S., Securities and Exchange Commission (SEC) guidelines require that funds lending securities receive at least 100 percent of the value of the loaned securities as collateral from a borrower. The value of the collateral must be marked-to-market daily and adjusted so that the Secretariat of the Financial Stability Board November 27, 2013 Page 4 of 6 obligations are fully collateralized at all times. As a practical matter, securities lending agreements typically apply a haircut, usually 102 percent for loaned domestic securities and U.S. dollar denominated foreign securities and 105 percent for loaned foreign securities. These standardized two and five percent haircut levels do not fluctuate based on stresses in the market—they are not lowered in benign market environments, nor raised in volatile markets. Moreover, the problems identified during the recent crisis with respect to securities lending collateral did not have to do with inadequate amounts of collateral; rather, the problems stemmed from losses and a lack of liquidity in certain cash collateral reinvestment pools, particularly those not managed in accordance with Rule 2a-7 under the Investment Company Act. Given all of that, the FSB's recommendation to require securities lending market participants to develop detailed methodologies to calculate risk-based haircuts is misplaced. The primary purpose for that recommendation—in the FSB's words, "to limit potential procyclical fluctuations, i.e. to moderate the extent by which the haircuts decline in benign market environments (and thus mitigate the magnitude of the potential increase in volatile markets)"—already is satisfied by the use of standardized two and five percent haircuts that do not fluctuate in times of stress. As we pointed out in our earlier comment letters, research in the tri-party repo market indicates, contrary to the Margin Consultation's premise, that margin haircuts in the repo market also are not pro-cyclical in nature but rather change very little during crisis or stress periods.⁸ While SEC guidelines require that funds lending cash in a repo transaction be fully collateralized at all times, repo transactions are typically over-collateralized at levels ranging from 102 percent to 110 percent, demonstrated by the collateral haircut data published monthly by the Federal Reserve Bank of New York.⁹ This data also shows little fluctuation in the range or median margin requirements for investment grade and equity collateral. Again, the value of the collateral must be marked-to-market daily and adjusted so that the obligations are fully collateralized at all times.

A Prescriptive Methodology May Create a De Facto Floor. Although the FSB separates its discussion of haircut methodologies from numerical haircut floors, the two approaches ultimately may produce the same result, as detailed minimum methodologies could have the practical effect of establishing minimum haircuts. For example, if market participants are required to calculate their haircuts by looking back at a similar period for price data for a type of collateral (e.g., at least two years and covering at least one stress period for that

type of collateral), use a similar confidence level in the calculation (e.g., at least the 95th percentile, one-tailed confidence level) and a similar liquidation horizon for the collateral (e.g., conservative period that reflects expected liquidity in stressed market 8 Repo Runs: Evidence from the Tri-Party Repo Market, Copeland, Martin and Walker, Federal Reserve Bank of New York Staff Reports, no. 506, July 2011; revised March 2012. 9 See, e.g., daily average collateral value and margin trends in the tri-party repo market, available at http://www.newyorkfed.org/banking/pdf/daily_avg_size_tpr_Sep2013.pdf. Secretariat of the Financial Stability Board November 27, 2013 Page 5 of 6 conditions taking into account trading volumes and market depth) the market participants are likely to arrive at substantially similar haircuts for a type of collateral. This would result in the FSB effectively setting minimum haircuts for collateral in the repo market, which we continue to oppose for the reasons discussed below. Again, we believe market participants should be free to set their haircuts at levels consistent with their own credit policies, repo trading practices and other factors specific to the market participant. We would also reiterate our early comments regarding how one method may not be appropriate for all counterparties. As noted in our previous letter, U.S. money market funds are required to consider a counterparty's ability to pay the repurchase price when assessing the credit risk of a repo transaction. This methodology, which is widely used by other participants in the repo market, focuses on the counterparty's capacity to repay all of its current obligations from sources other than the liquidation of the collateral. This methodology is appropriate for repos with a counterparty that has access to liquidity from a variety of sources. It may not be appropriate for a prime broker's repos with a hedge fund, for which the only source of repayment would be from liquidation of the fund's portfolio. The "one method fits all" approach proposed in the consultation overlooks such important distinctions.

Section 4: Numerical Floors on Haircuts We appreciate that the FSB has carefully crafted the scope of its proposed framework of numerical haircut floors to address situations where the primary motive is to provide financing to non-banking entities. Accordingly, the FSB has excluded cash-collateralized securities lending and limited the scope to "non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing from regulated financial intermediaries against collateral other than government securities." This formulation correctly excludes transactions backed by government securities and transactions where the non-bank is providing financing, such as where it is the repo cash lender. Narrowing the scope in these ways alleviates many of our concerns.¹⁰ That said, we continue to believe that the FSB's efforts to prescribe specific fixed or minimum numerical haircut floors is both unwarranted and unnecessary. Fundamentally, we believe that the economic terms of a repo are best set by market forces, responding to current market conditions and a multitude of other factors that regulations can never adequately capture. Moreover, as noted above and in prior comment letters, research in the tri-party repo market indicates, contrary to the Margin 10 The FSB's recommendations on haircut methodologies, however, may undermine its policy decisions with respect to the scope of its proposed framework of numerical haircut floors. As noted above, the two approaches ultimately may produce the same result as detailed minimum methodologies could have the practical effect of establishing minimum haircuts, and thus the broader scope of the recommendations on methodologies may override the narrower scope of the recommendations on numerical floors. To avoid that result, if the FSB goes forward with these recommendations, it should adopt the narrower scope used in this section for both haircut methodologies and numerical floors. Secretariat of the Financial Stability Board November 27, 2013 Page 6 of 6 Consultation's premise, that margin haircuts are not pro-cyclical in nature but rather change very little during crisis or stress periods. This may be, in part, because buyers enter into a repo based primarily upon the seller's capacity to pay the repurchase price, rather than upon the value and liquidity of

the collateral. That the proposed levels of the numerical floors are lower than those currently employed in the market does not diminish our concerns, but in fact, instead demonstrates the danger in prescribing these types of terms. The 2012 consultation set out a two-tier framework with haircuts that were much higher than were those prevailing in the market. Haircuts at those levels threatened to make repos economically unviable. The Margin Consultation goes the opposite direction, setting out a schedule of haircuts at much lower levels, lower even than many of the levels currently employed. While haircuts at the lower levels suggested by the Margin Consultation would not inhibit repo trading, they run a very real risk of becoming de facto market standards. Perversely, this would have precisely the opposite effect as intended, decreasing the protections afforded by collateral and increasing the amount of leverage and risk in the system. For all of these reasons, we see the FSB's attempt to limit the market's ability to set the terms of repos, including haircuts, to be a counterproductive policy. * * * * We appreciate the opportunity to comment on this consultation. If you have any questions about our comments or would like additional information, please contact me at 202/371-5430 or rcg@ici.org, Giles Swan, Director of Global Funds Policy at ICI Global at +44 (0) 203 009 3103 or giles.swan@iciglobal.org, or Brian Reid, ICI's Chief Economist, at 202/326-5917 or reid@ici.org. Sincerely, /s/ Robert C. Grohowski Robert C. Grohowski Senior Counsel APPENDIX A – Prior Comment Letters to the FSB on Securities Lending and Repo Markets Letters on WS5's Interim Report Investment Company Institute, dated May 25, 2012

https://www.financialstabilityboard.org/publications/c_120806p.pdf ICI Global, dated May 25, 2012 https://www.financialstabilityboard.org/publications/c_120806g.pdf Letters on the FSB's November 2012 Consultation Investment Company Institute, dated January 14, 2013 http://www.financialstabilityboard.org/publications/c_130129at.pdf ICI Global, dated January 14, 2013 https://www.financialstabilityboard.org/publications/c_130129ar.pdf