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Interim Report of the FSB Workstream on Securities Lending and Repos: Market Overview and Financial Stability Issues

Dear Sir or Madam,

BVI[1] welcomes the opportunity to contribute to the international debate on regulatory policy towards securities lending and repos. We thank the FSB for disclosing its preliminary findings to the interested market participants.

General remarks

We understand that securities lending and repos are being perceived by the FSB as principal shadow banking activities because of the potential to facilitate maturity/liquidity transformation and to contribute to the build-up of leverage. Against this macro-prudential backdrop, we highly appreciate that the discussion is being led on the activities as such, without any restrictions in terms of affected market participants.

[1] BVI Bundesverband Investment and Asset Management represents the interests of the German investment fund and asset management industry. BVI`s offices are located in Berlin, Brussels and Frankfurt. Its 82 members currently handle assets in excess of EUR 1.8 trillion in both investment funds and mandates by managing directly or indirectly the capital of 50 million private clients in 21 million households. For more information, please visit www.bvi.de.

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As representatives of the German regulated investment fund industry, we would like to express our sincere interest to actively contribute to development of international regulatory standards in this field. Indeed, we think that the significant regulatory experience of the German fund sector should be duly considered in the current debate. The legal framework for securities lending by investment funds in Germany was introduced by the Second Financial Market Promotion Act ("Zweites Finanzmarktförderungsgesetz") in 1994 and has remained in place without significant modifications ever since. The leading motive of the German legislator has been to establish an additional source of income for fund investors while avoiding additional risks[2]. Hence, the applicable measures focus on reducing counterparty risk from and ensuring appropriate collateralization of securities lending transactions on behalf of investment funds.

As these provisions have been proven and tested in practice for many years, we recommend the FSB to consider the German model and similar fund regulations in other jurisdiction as a regulatory benchmark for other market participants. In combination with the reporting duties to become mandatory in Europe in relation to securities lending and repos[3], we believe these measures adequate to address most concerns identified by the FSB.

Specific comments on the interim report

As regards the market analysis and first general conclusions presented in the FSB Report, we would like to submit the following:

1. Market Overview: Four market segments

Traditional investment funds such as European UCITS and other securities funds with UCITS-like set-up[4] are certainly active in the "securities lending segment", but should not be associated with the "leveraged in-

[2] Cf. Official Record of the German Bundestag (BT-Drs.) 12/6679, pages 37,79-80.
[3] Cf. our comments on section 5.1 below.
[4] The term "traditional investment fund" used throughout the paper refers to UCITS and other regulated and supervised investment funds investing predominantly in transferable securities. It is meant in the first place as a distinction from hedge funds and hence assumes that the framework for "traditional investment funds" allows for only limited leverage, no borrowing of securities and no physical short selling. In Germany, virtually all securities funds, including those issued for institutional investors, can be considered "traditional" in this sense.

vestment fund financing and securities borrowing segment". Leverage in UCITS can be only incurred through the use of derivatives as direct borrowing is limited to temporary transactions not exceeding 10% of the fund assets[5]. Hence, the 140:40 (or usually 130:30) strategies mentioned in footnote 11 are realized solely by taking short positions through derivatives and have nothing to do with borrowing of securities for the purpose of physical short selling. The reverse repo transactions occasionally concluded by traditional investment funds are also not suitable to create leverage in the fund portfolio.

In this context, we would like to counter the misconception that "except in the US, both the borrower and lender can (…) sell or use assets received under securities lending transactions as collateral in other transactions"[6]. The German law generally prohibits investment funds from re-using the received collateral other than cash which must be kept in custody with the fund's depositary or, provided the latter's consent, with another eligible credit institution. Cash collateral must be either kept in blocked accounts or may be invested in risk-free money market instruments issued in the fund's currency[7]. Deviations from these rules are possible only for funds dedicated exclusively to institutional investors (so-called Spezialfonds).

2. Five key drivers of the securities lending and repo markets

"Financing needs of leveraged intermediaries" (2.2) and "facilitation of hedge fund and other investment strategies involving leverage and short selling" (2.3) are for the above-stated reasons of little to no relevance for European traditional investment funds.

With regard to "the increasing need to gain access to securities for the purpose of optimizing the collateralization of repos, securities lending and derivatives" (2.4), we would like to point out that after entry into force of the European Market Infrastructure Regulation EMIR due for beginning of 2013, a sharp increase in the market demand for liquidity must be anticipated. This is due to the fact that the central clearing of standardized OTC derivative contracts to become mandatory under EMIR will require collateralization with highly liquid assets. Similar standards are cur-

[5] Cf. Article 83(2) of Directive 2009/65/EC (UCITS IV-Directive).
[6] Cf. Annex 1 section 1.1 on page 20 of the FSB Interim Report.
[7] § 54 para. 2 of the German Investment Act (Investmentgesetz).

rently under discussion for collateralization of bilateral OTC trades. European investment funds, however, have only limited liquidity reserves due to the applicable investment rules which require that liquidity is either invested in eligible portfolio assets or used to satisfy redemption requests by investors. Thus, while European investment funds may currently raise liquidity by engaging in repo transactions, the option of re-using cash collateral from securities lending for the purpose of collateralizing OTC derivative positions as reported to the FSB[8] is not available to German and many other European investment funds due to the ban on re-hypothecation mentioned above.

Lastly, in view of "demand for return enhancement by securities lenders and agent lenders" (2.5), it should be noted that German investment funds are subject to strict requirements as regards reinvestment of cash collateral from securities lending transactions (cf. supra). Hence, the strategy of treating cash collateral as a source of financing for leveraged investments described in the Interim Report is generally not pursued by German investment funds. In future, reinvestment of cash collateral in non-risk-free assets shall be banned for all UCITS according to the recent ESMA's proposal[9].

3. Location within the shadow banking system

We reject the notion that "borrowing through repo financing markets (…) creates leverage" (point (i)). Under the standard master agreements used by the investment fund industry, repo transactions involve the obligation to repurchase the relevant assets at a price which usually represents the original sale price plus the agreed interest. Any variations in the market price of the assets subject to repo transactions are subject to collateralization. Hence, we see no potential to effectively increase the market exposure of a vehicle by engaging in repo trades.

As regards points (ii) to (iv), the depicted risks are non-existent in UCITS and traditional German investment funds which are neither allowed to borrow securities nor engage in physical short-selling[10].

[8] Section 2.5 last paragraph on page 8 of the FSB Interim Report.
[9] Cf. Para. 51 on page 19 of the consultation paper „ESMA's guidelines on ETFs and other UCITS issues" (ESMA/2012/44).
[10] Cf. §§ 54, 59 of the German Investment Act.

4. Overview of regulations for securities lending and repos; requirements for investors

From the German perspective, we have the following remarks on regulation of investment funds:

- **Counterparty concentration limits:** Securities lending to one counterparty is limited on a gross basis to 10% of the fund's NAV. Transactions with several counterparties belonging to the same corporate group are all counted towards the same limit[11].
- **Collateral guidelines:** Exposure to counterparty risk from securities lending transactions must be fully collateralized at all times[12]. Assets eligible as collateral are debt securities acknowledged by the ECB or the Deutsche Bundesbank as collateral for credit transactions or shares admitted to trading on a regulated market[13]. Any correlation between the borrower and the issuer of the security collateral must be avoided[14]. Non-cash collateral must be kept in custody by the fund depositary or with its consent, by another suitable credit institution and thus, cannot be re-invested, pledged or sold[15]. Cash collateral must be either deposited in blocked accounts or invested in money market instruments as noted in the interim report[16].
- **Transparency:** German fund managers are obliged to report immediately towards BaFin if the value of the received collateral drops below the value of the securities on loan. Recently, significant reporting requirements pertaining to securities lending and repos have been adopted for German and European investment funds (for details, see our comments on section 5 below).

5. Financial stability issues

The purported lack of transparency in securities financing markets (section 5.1) does not pertain to the German market for investment funds. The German supervisory authority BaFin has only recently imposed an obligation for all investment funds domiciled in Germany to report on an

[11] Cf. § 54 para. 1, second sentence of the German Investment Act.
[12] § 54 para. 3, third sentence of the German Investment Act.
[13] § 54 para. 2, sixth sentence of the German Investment Act.
[14] § 54 para. 2, seventh sentence of the German Investment Act.
[15] § 54 para. 2, third sentence of the German Investment Act.
[16] § 54 para. 2, second sentence of the German Investment Act.

annual basis the volume of their securities lending, repo and reverse repo transactions both for the entire reporting period and at the closing date[17]. This new reporting requirement has been perceived as a consequence of implementing the EU UCITS IV reform and we expect that other EU Member States also introduced similar standards in their jurisdictions at least with regard to UCITS.

For other investment funds, the new EU Directive on Alternative Investment Fund Managers AIFMD is expected to require extensive regulatory reporting by most funds on a quarterly basis[18]. These reports shall encompass information on borrowing and exposure risk of each managed fund, including value of borrowings of cash or securities, value of securities borrowed for short positions as well as value of collateral posted to other counterparties and where applicable, percentage of its rehypothecation[19]. These details represent only a small fraction of the very challenging reporting requirements to become incumbent on fund managers which for the time being must not be further intensified.

In terms of micro-level data and risk surveillance, it should also be noted that suitability and extent of collateralization is controlled on an ongoing basis by the fund's depositary.

As regards further financial stability issues discussed by the FSB, we would like to make the following observations:

- **Value of collateral securities and haircuts (5.2.1 and 5.2.2):** While understanding the concerns in terms of procyclicality of collateral valuation, we do not think that there are reasonable policy options in order to remedy this situation. Lenders of securities need to adequately collateralize their counterparty risk, whereas on the borrower side, there should be no inclination to over-

[17] Cf. § 28c of the Ordinance on risk management and risk measurement concerning the use of derivatives in investment funds (Derivateverordnung) and section 2.4 and 3.3. of the corresponding instructions by BaFin.

[18] Cf. Box 110 of the Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (ESMA/2011/379).

[19] Q 17, 18, 28 and 30 of the pro-forma for AIFM reporting presented in Annex V to the Final Report on ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (ESMA/2011/379).

collateralize transactions to an extent not justified by specific market circumstances. Thus, requiring stable haircuts on certain assets would in our view significantly impede the market for securities financing with potentially fewer borrowers willing to accept economically unattractive terms of collateral commitment. Also, it is important to bear in mind that in the market practice cash collateral is only being provided in exchange for interest payment. Re-investment of cash collateral in money market instrument is therefore necessary for generating interest yields to be paid to the borrower.

- **Collateral velocity (5.2.3)** is irrelevant to most German traditional investment funds as they are prohibited from re-using the received collateral and hence cannot contribute to lengthening the "re-pledging chains".
- **Potential risks from fire-sale of collateral assets (5.4):** German fund managers are bound to accept only highly liquid securities for collateralization of securities lending which fairly reduces the risk of market turmoil in case of collateral sales. Besides, the volume of collateral for securities lending or repo transactions appears to be minor compared to the anticipated collateral needs by CCPs in the context of OTC derivative clearing. Indeed, we think that limitation of eligible collateral for CCP clearing to only a few asset categories as envisaged under EMIR might much stronger increase the stability risk from fire-sales than any realization of collateral by securities lenders.
- **Shadow banking through cash collateral reinvestment (5.6):** As explained above, German investment funds are only allowed to invest cash collateral in eligible money market instruments and consequently display only a limited potential for maturity transformation. The liquidity risk concerns can be mitigated by appropriate liquidity risk management measures in terms of collateral reinvestment.
- **Insufficient rigor in collateral valuation and management practices (5.7):** We do not understand the reference to the inadequate valuation practices observed in the MBS market. Should the FSB aim at streamlining or enhancing the valuation standards for collateral, we would be glad to contribute to the corresponding regulatory debate.

On balance, the above remarks clearly demonstrate that many of the deficiencies and concerns identified by the FSB are not relevant to the traditional investment fund industry in Germany. The high regulatory standards applicable to securities lending by investment funds ensure that the corresponding risks for both the fund investors and markets are adequately mitigated. The strict reporting requirements towards regulators to come shortly into force at European level will equip the authorities with the necessary data for monitoring potential risks to financial stability. Hence, we believe that further regulatory steps at international level should focus on introducing equivalent standards for other market participants in other parts of the world.

We remain at the FSB's disposal for any questions or further in-depth discussion of our standpoints.

Yours sincerely

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