PASLA PAN ASIA SECURITIES LENDING ASSOCIATION Local Regulations, Global Standards

ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

rma THE RISK MANAGEMENT ASSOCIATION Serving the Financial Services Industry

Secretariat of the Financial Stability Board
C/o Bank for International Settlements
CH-4002
Basel, Switzerland

VIA ELECTRONIC COMMUNIQUE

25TH May 2012

ISLA, RMA and PASLA joint response to the Interim Report of the FSB Workstream on Securities Lending and Repos.

Dear Sirs,

On behalf of the Committee on Securities Lending of the Risk Management Association ("RMA"), the International Securities Lending Association ("ISLA") and the Pan Asian Securities Lending Association ("PASLA") we are pleased to provide comments on the Interim Report of the FSB Workstream on Securities Lending and Repos (the "Report"). RMA represents agent lenders within the securities lending industry in North America. ISLA and PASLA represent agent lenders and broker-dealers who participate in the securities lending markets in Europe and Asia. More details about each association can be found at the end of this letter. Accordingly our comments are focused on matters relating to the securities lending and leveraged investment funds/ securities borrowing market segments identified by the Workstream.

We are grateful to the FSB to have been included in the consultation and market evaluations thus far and are keen to continue to assist the FSB as it considers the next phase of its analysis and policy making. Included in to this letter are our thoughts on a number of specific matters raised in the Report, but we would first like to emphasize some principles about the approach to reviewing securities lending in the context of shadow banking.

Securities Lending and Shadow Banking

Generally we believe that the Report provides a comprehensive and well-reasoned assessment of the securities lending market. We agree that it is helpful to consider the securities lending and repo markets as two distinct segments and to identify the specific elements within each that are relevant to the shadow banking discussion.

Our members have had a long history of developing responsible market practices which have generally served this market and beneficial owners well. That said we recognize the need for review and that it is in all stakeholders' interests to ensure that the market is subject to sufficient regulation which will allay policymakers' concerns about possible future developments and avoid repeats of the types of isolated practices (such as AIG's cash collateral reinvestment strategy) that are discussed in the Report.

It is important however to ensure that regulation delivers these benefits in a consistent manner without harming the material benefits that securities lending brings to investors, beneficial owners and the markets more broadly.

Securities lending provides direct benefits to institutional investors such as pension plans, mutual funds and insurance companies ("beneficial owners"), by enabling such investors to generate low risk incremental returns on their investment portfolios. These returns enhance performance over time and may substantially help long-term investors reduce the costs of managing their portfolios, as well as defray administrative expenses and offset pension liabilities.

At the same time securities lending also provides substantial benefits to the wider capital markets, enabling higher levels of settlement efficiency and increased liquidity. Without securities lending it would be prohibitively more expensive and risky for investment firms to make markets in a wide range of securities, and more difficult for investors to hedge investment positions or engage in trading strategies such as arbitrage. Securities lending is therefore a very important contributor to the functioning of the secondary markets.

Care is needed when considering policy options so as not to unnecessarily deter participation in securities lending markets and thereby deprive beneficial owners of available income and the markets of valuable liquidity. Whilst such long term investors value securities lending returns, the vast majority consider the activity to be ancillary to the core investment management process and therefore to some extent discretionary. They are also by their nature risk averse institutions who have taken time to understand how risks are managed and maintained at low levels in their programs today. Regulatory requirements that alter the risk or return dynamics in ways that these investors perceive as negative, or that increase the complexity or cost of doing business, may well cause many to withdraw from the market. By way of example, a large UK pension fund stated that it would certainly withdraw from lending if it were required to place its securities lending activity through a central counterparty, for reasons further clarified within our specific comments further below.

Of the issues raised in Section 5 of the Report we strongly support more discussion about transparency. Whilst securities lending markets are sometimes referred to as opaque, much has developed in this area over the past decade to mitigate this concern. Institutional investors who lend through agents are provided with comprehensive reporting of their securities lending activity and codes of practice have been developed in the US and Europe that cover this. Market data is collected and disseminated by independent firms to market participants and investors on a commercial basis as well as to those regulators that request it, and this information has become widely used by market participants for benchmarking and peer comparisons. That said, we accept that not all regulators have sought access to such market data, and that such market data is only available on a fee paying basis. We would also acknowledge that the data currently being collected may not fully meet the needs of regulators charged with reviewing systemic risk. We are keen to engage further with the FSB on this area and believe that there may be lessons to be learned from initiatives in other OTC markets such as the development of trade repositories.

Whilst there are nuances that distinguish securities lending in different markets around the world, the principles of the business are the same and many participants engage in the business on a global basis. We therefore welcome the FSB's involvement in reviewing securities lending on a global basis and encourage the development of proportionate and consistent global policies which we hope national regulators will support.

We appreciate efforts by the FSB to ensure that the benefits of securities lending to investors and the markets continue to be emphasized. We believe that the Report does highlight these benefits but it remains important that future outputs and comments from the FSB continue to stress that shadow banking and securities lending are not cast unnecessarily in a negative light.

Below are some specific comments on points made in the Report. We hope that you find this letter and our comments useful when considering the next stage of your work. As already mentioned, we remain at your disposal and look forward to working with you.

Lack of transparency

We accept that there is a need for appropriate transparency to regulators around the world to ensure they are aware of developments in the securities lending markets as they pertain to systemic risk. We are keen to work with the FSB in this area and are in the process of considering what options may best suit the regulators' needs. We would strongly support a global approach to this issue such that there are no differences in the reporting obligations of market participants in the major markets of the world.

Securities lending has become increasingly transparent over the past decade. Typically beneficial owners or their proxies have access to transaction level data for their lending programs, which show at a minimum the percentage on loan per security, the collateral received, and the fees or rebates associated with such transactions. Beneficial owners who accept cash collateral also have access to the reinvestment portfolio holdings and current mark to market values by asset held within the reinvestment portfolio. RMA, ISLA and PASLA have worked with local regulators to create best practice papers addressing, among other things, disclosure and transparency for securities lending agents. Please see the following links: http://www.rmahq.org/securities-lending/best-practices
http://www.isla.co.uk/bestpractices
http://www.paslaonline.com/static6.html

Many market participants also provide transaction level data to industry data aggregators, which is used by lenders and lending agents to assess relative performance of their programs. This data is provided on a daily basis. Whilst there are few regulatory requirements around the world to report securities lending data, we believe that the majority of securities lending transactions are already being reported to one or more of the existing data aggregators.

To the extent that the efforts of the securities lending market to date, have not met the regulators needs with respect to transparency, we have a keen interest in working with the FSB to address such needs. There are benefits and disadvantages with mandated requirements for achieving transparency adopted in other OTC markets however it is our firm belief that any requirements must be based on access to and analysis of data covering all markets, entities and transactions to which the requirements would apply. Trade Repositories offer one alternative for collating data across different markets, entities and transactions and could be a necessary pre-cursor to any proposal to involve Central Counterparties ("CCPs") in the securities lending market. CCP's are often viewed as a potential source of increased transparency and risk reduction within the securities finance industry. However, to date a CCP model has not been implemented in the securities lending market that either provides a reduction in counterparty risk for beneficial owners (or their agents) or does not negatively alter the economics or breadth of the securities lending market. We recognize that these are challenges that CCPs are aware of and may look to address in the future.

Procyclicality of system leverage/interconnectedness

If regulators are concerned about growth in system leverage we believe it is better to consider ways of addressing this directly, rather than through the securities finance market. Before considering policy options in this area we believe that further analysis is required to ensure the concerns are justified and need to be addressed and that the measures do not unduly detract from the benefits that securities lending provides.

By way of example, the Report points out that the value of securities lending cash collateral fell significantly during the autumn of 2008. While this was highly correlated with the decline in equity market values, it was not solely driven by this factor. The decline of the equity markets, in and of itself, was likely not a significant factor in the reduction in securities lending and associated cash collateral reinvestment. This can be surmised based on the correlations between equity markets, securities lending balances, and cash reinvestment since the market bottom. Equity markets have increased significantly since the reaching their lows in early 2009. For instance the S&P 500 has doubled since the bottom. However, since that point, securities lending balances have increased only modestly. From the first quarter of 2009 to the first quarter of 2012, securities lending balances were up less than 3% (RMA quarterly survey) and the amount of cash collateral has not risen since 2009 due to a shift towards greater use of non-cash collateral.

Therefore, other explanations for the decrease in securities lending and cash reinvestment balances should be examined to determine whether these are cyclical or structural in nature. Some potential explanations include the following:

1) Deleveraging of end borrowers of securities (i.e. hedge funds).

2) Changes in the composition, regulation and structure of the prime brokerage market.

3) Changes in capital requirements which will dampen the ability to increase leverage.

4) The imposition of short selling bans which may have exacerbated procyclicality.

5) Increased U.S. Treasury supply and the Zero Rate Interest Policy in the U.S. which dampened the economics of lending US Treasuries.

6) Actions of beneficial owners with respect to their investment appetite.

While a shock in the securities lending market will impact the amount of funds available in the money markets, it should be noted that most transactions are in the shortest part of the curve, which will be most directly impacted by such a shock, and generally with the same set of counterparties as the securities lending transactions. Thus, with the occurrence of such a shock, not only does the availability of short term money market funding decrease, but it is directly correlated with an offsetting requirement for short term money market funding.

The Report discusses the potential role that haircuts may play in contributing to procyclicality and we agree with the Report's findings that overall haircuts were maintained at relatively stable levels. The bilateral nature of the business and the somewhat diverse collateral types accepted by lenders prior to the crisis caused a more gradual shift toward more protective haircuts across the whole market than if all transaction had been centrally cleared. Whilst the use of less liquid non-cash collateral in securities lending (such as ABS) was growing in the lead up to the crisis these collateral types represented a very small proportion of the overall market.

We understand that some policymakers have suggested the imposition of minimum haircuts designed to reduce the need for upward revisions in times of market stress. Whilst this idea has some theoretical merit it potentially creates other risks – if the minimum is set too high, it may make the business of securities lending uneconomic for certain parties, and the market benefits of the activity are lost. If set at more realistic levels, a regulatory minimum may create moral hazard, as participants rely on this level at the expense of performing their own risk analysis. We would support further discussion in this area to consider the feasibility of achieving desired goals without sacrificing critical market liquidity.

Other potential financial stability issues associated with collateral re-use

Typically beneficial owners do not allow or want the re-use of non-cash collateral arising from securities lending transactions. Whereas cash collateral can be re-used (i.e. reinvested), it is generally used to purchase short term money market like instruments. The risks associated with such transactions are discussed in our comments regarding the fire sale of assets and shadow banking through cash collateral reinvestment.

In the context of prime brokerage, rehypothecation is a vital component of the financing relationship. Prime brokers lend clients' money to buy assets, prime brokers then need to be able to rehypothecate those financed assets so that they can be used in financing transactions, typically repo transactions, in order to finance the money that the prime broker has lent to the client. In this way client driven margin financing is self-funding within the wider institution. We agree with the sentiment that outside of a regulated bank environment, the rehypothecation of customer assets should not support a firms own principal investment to a material extent, and support the notion that rehypothecation should remain permissible within a margin financing business where the financing generated is primarily used to support the financing needs of clients of that business whether the prime broker in question is a bank or not. In this regard we welcome the fact that the FSB has recognized the key regulatory capital regimes that are applicable to both banks and broker-dealers, which operate to ensure similar capital standards are applied to those banks and non-banks (such as broker dealers and investment firms) participating in prime brokerage, rehypothecation, securities lending and repo activities.

The level of rehypothecation that is permissible by a prime broker remains a commercial matter rather than a regulatory one in most jurisdictions and it is important to remember that prime brokers rehypothecate client assets in order to generate financing and not to provide security against a client default.

Rehypothecation levels are usually expressed as a percentage (%) of client indebtedness and those levels generally exceed the amount of financed indebtedness, in order to reflect the prime broker's own haircut to its financing counterpart in the funding markets. Financing client activity has a significant amount of embedded inefficiency which is reflected in the rehypothecation limits agreed with clients. The inefficiencies arise for a number of reasons, including a prime broker's inability to use all of a clients financed assets during every day of the term of the loan, assets have to be recalled from financing transactions early to settle client sales and may be required to be held in the clients account over corporate action events. The excess rehypothecation over the indebtedness supports both the financing haircuts the broker will have to provide as well as the inherent slippage in the financing chain.

In the United States where there is a regulatory limit on rehypothecation of 140% of indebtedness, this limit does take account many of the factors we have described above. Any move to set lower limits on a global basis would risk significantly impacting the ability of banks and broker dealers to provide efficient self-funded margin financing solutions to clients.

We welcome the application of appropriate global standards for rehypothecation which provide transparency, both in respect of transactions which we support being reported through trade repository and made available to regulators and for clients who are not banks or broker dealers through appropriate disclosure which may include disclosure of contractual rehypothecation limits, key risks and regular reporting of rehypothecated assets. In this regard we would highlight your reference to the U.K. FSA client asset rules which now require prime brokers to provide enhanced transparency to clients through a daily report, showing those assets which have and have not been rehypothecated.

Potential risk arising from fire-sale of collateral assets

As the FSB correctly points out, when a counterparty defaults the lender would typically need to raise cash in order to replace securities that have been lent to the defaulting counterpart. This would be accomplished through a three step process:

1) Liquidation of non-cash collateral
2) Use of maturing reinvestment securities
3) Sale of reinvestment securities

As lenders generally maintain significant liquid assets within their reinvestment pools, the third step would generally be unnecessary upon the event of default.

As exhibited during the 2008 credit crisis, due to the high percentage of collateral that is either G-7 sovereign debt or cash reinvested in overnight maturities and highly liquid short duration assets, securities lenders are generally net purchasers of non-sovereign securities in the event of a borrower default. If there is concern that there is no incentive to maintain high levels of liquidity in cash collateral investments, this could easily be addressed from a systemic point of view through the transparency efforts previously discussed.

Potential risk arising from agent lender practices

The FSB points out the potential consequences that may arise from agent lenders offering borrower default indemnifications. One concern raised is that borrower default indemnification could lead to beneficial owner's no longer screening and monitoring borrowers. All beneficial owners continue to have transparency into the borrowers of their securities with regard to securities on loan and collateral received. Each beneficial owner also has the ability to eliminate or restrict certain borrowers. Thus, the ability for beneficial owners to perform credit due diligence is not reduced through an indemnified agency lending program. More importantly, the agent indemnification of securities loans leads to greater incentives for lending agents to more thoroughly screen and monitor counterparties and adjust exposures accordingly. As the agent lender negotiates and manages the securities lending process, they are better suited than the beneficial owners to perform the credit screening and monitoring. In fact the credit screening and monitoring costs would be prohibitively expensive for all but the largest and most sophisticated beneficial owners. In addition, the agent lender is also able to better monitor and assess the overall level of loans and collateral transacting through its institution than would a beneficial owner.

Shadow banking through cash collateral reinvestment

When a beneficial owner utilizes an agent lender, the cash collateral reinvestment is often undertaken by the agent lender (typically in separately managed accounts or commingled funds) on behalf of the client based on investment guidelines that are agreed upon by the beneficial owner and the agent lender. Therefore, based on the agent lender making both the loan and reinvestment decisions, under such arrangements the beneficial owner is unable to perform "bank-like" activities. Rather, the agent lender is generally responsible for loan, collateral and reinvestment decisions. These decisions must conform to previously agreed upon guidelines, which limits the degree of credit and maturity transformation undertaken. The agent lender is typically an entity that is regulated by a financial regulator in an established market or by prudential regulation, thus ensuring proper oversight. It is also important to distinguish agency securities lending from principal securities lending and cases such as AIG. Today, a vast majority of agency lending cash collateral is reinvested in short-term money market eligible instruments and A1/P1 rated repurchase agreements. In contrast, as noted by the FSB, AIG's cash collateral was reinvested in long-term, highly illiquid debt instruments.

It is often stated that within an agent lending program clients bear the responsibility for any cash collateral loss whereas the profits are shared. Generally this is a misstatement of facts. Within an agent lending program the clients are generally responsible for any principal gains or losses within the reinvestment portfolio. However, profits and losses resulting from the difference between yields and rebates are generally shared by both entities based on a pre-arranged fee split.

Lastly, while some clients have in fact migrated from commingled funds to separately managed accounts, commingled funds remain a critically important cash reinvestment option for small to medium sized lenders due to such funds' economies of scale. It should be noted that many commingled funds used by this segment have migrated to fairly conservative investment guidelines. In general, these commingled funds tend to be managed with a very conservative perspective.

Insufficient rigor in collateral valuation and management practices

It is market practice for collateral (whether securities or cash reinvestment) to be valued on a daily basis. Collateral is then adjusted daily to reflect changes in valuation of both loans and securities received as collateral (i.e., daily marks to market). While collateral re-investment portfolios generally transact at a stable value, actual portfolio net asset values are typically made available to beneficial owners on a frequent, if not daily, basis.

During the recent credit crisis, significant changes in valuation were exhibited by some asset classes due to less than anticipated liquidity for certain securities. It should also be noted that the change in valuations for a number of these securities did not reflect the true credit exposure associated with the underlying fundamentals of the securities, but rather the new valuations were based on fire sale prices received by some market participants during the crisis.

Benefits of Legal and Regulatory Consistency

Concerns with respect margin levels and procyclicality may be better addressed by developing more detail and clarity with respect to the implementation of recent proposals on resolution regime principals and urging policy makers to create more flexibility and legal certainty with respect to the enforceability of contractual cross-principal and cross product close-out netting provisions. Greater certainty around resolution regime procedures in regards to which entities are subject to the regime and how securities lending and repurchase transactions could be structured to insure transfer to a bridge entity or a third party would reduce the probability of lenders curtailing business or increasing haircuts during periods of market stress. Further, increased certainty with respect to cross principal and cross product close-out netting provisions negotiated by agent lenders with counterparties would also reduce the likelihood of procyclical changes in haircuts. As previously noted, lending counterparties are frequently repo counterparties as well. Thus, enforceable cross product close-out netting would result in a higher effective margin without having to change actual margins. Cross principal netting further enables agent lenders to manage the collateral received and loans placed with a single entity at a portfolio level, thereby taking advantage of correlation effects which reduce the need for higher margins.

Conclusion

We greatly appreciate having the opportunity to review and respond to the Interim Report of the FSB Workstream on Securities Lending and Repos. As noted we viewed the Report as a comprehensive and reasonably sound depiction of the securities lending market. We believe that it is important that great care is taken when proposing regulatory and policy options, as securities lending plays a vital role in developed capital markets. We would hope that policy options would not be proposed without considering all of the potential consequences weighed against any expected benefits and must be global in nature to avoid regulatory arbitrage or create unwanted inconsistencies across regimes.

In particular, we would note that transparency to market participants has improved substantially over the past decade and this trend is set to continue. We recognize the importance of transparency of securities lending activities to regulators around the world and welcome the opportunity to work with the FSB to develop options that will provide regulators with the necessary information without inflicting an undue cost burden on market participants. Also, we believe it is important to more thoroughly study the procyclicality of securities lending to determine what other factors may have impacted balances during late 2008 and early 2009 before prescribing policies that may negatively impact markets. Consideration of changes within the market, including the composition of key players, as well as steps already taken by regulators should also be taken into account before further policy recommendations are proposed.

While we appreciate the thoroughness and logical conclusions made within the Report, we urge the FSB to carefully consider the information provided within this comment letter before making policy recommendations. Careful study should be given to determine the cause of certain outcomes experienced during the recent credit crisis to ensure that such recommendations will be effective without negatively impacting the significant value derived by investors, beneficial owners, and global markets through securities lending.

Yours faithfully

PASLA	ISLA	RMA
Martin Corrall		*Christopher R Kunkle*
Martin Corrall **Chairman PASLA EC**	**Kevin McNulty** **CEO**	**Christopher R. Kunkle** **Director**

RMA, ISLA and PASLA

RMA

Founded in 1914, The Risk Management Association (RMA) is a not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry. RMA helps banking and nonbanking institutions identify and manage the impacts of credit risk, operational risk, and market risk on their businesses and customers. We achieve that through education, research, networking, and leadership opportunities.
As an industry leader in providing securities lending conferences and round tables, RMA is proud to represent the financial services industry and bank regulatory agencies, acting as a liaison for member institutions as they manage new legal and regulatory requirements in this ever-changing economy. In support of that role, RMA has several securities lending related councils and committees—including the Securities Lending Executive Committee, the Securities Lending Legal, Tax & Regulatory Group and the Securities Lending Operations Group—to promote sound lending practices among its members and the industry.

ISLA

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers, who in turn represent more than 4,000 clients. While based in London, ISLA represents members from sixteen countries in Europe. For more information please visit the ISLA website www.isla.co.uk.

PASLA

PASLA was incorporated in Hong Kong in 1995, and is an association of firms that are active in the business of borrowing and/or lending securities of Asian markets.
PASLA's membership includes Lenders, Borrowers and Investment Funds who are domiciled across multiple continents. PASLA regularly conducts seminars and round-tables with regulatory authorities and market participants in the local markets. This has proved to be a successful formula by providing an open forum for discussion and exchange of information. Our feedback from regulators and exchange officials that PASLA has worked with to-date has been very positive and they have appreciated the ability to work with PASLA as an efficient means of liaising with the industry.