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Financial Stability Board
FSB

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AFG's response to the FSB's Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity given by the FSB to comment on the Interim Report on Securities Lending and Repos circulated last April and currently open for comments.

We understand that this interim report is largely a description of market activities that concern asset managers to a small extent and shall not be in a position to comment on all issues raised. Nevertheless it intends to draw the regulator's attention to some points that are of relevance for its business.

Generally, we fear that the buy side's reasonable use of repos or securities lending might be very much harmed by a regulation attempting to refrain excessive and risky attitudes that the

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

fund management industry never can nor wishes to adopt. When speaking of fund management:

• Collateralised transaction is far less risky than non-collateralised; as a consequence AFG supports the view that EMIR and Dodd Frank route towards collateralisation of standardised and liquid OTC derivatives is appropriate; in other words, one should not take secondary considerations for prime objectives.

For example, it is safer for a money market fund to invest cash in a reverse-repo than to deposit it at a bank or buy a CD: it offers a senior collateralised debt safer than a senior non collateralized debt. For longer term investment reverse-repo even offers certain safety benefits compared to covered bonds (which are another type of collateralised debt). Indeed the collateral received in a reverse repo is by nature more transparent and more accessible because the investor knows exactly which assets he receives and can sell them directly in case of default, since these assets' property was already transferred to him and not pledged in a separate vehicle.

• Proper and reasonable use of securities lending and repo by funds that are already heavily regulated should not be assimilated to improper and excessive use of the same instruments by non regulated shadow banking entities; in other words, shadow banking has to be regulated but not forbidden.

For example, the report recommends the tri party repo as a better practice. It is probably not the case for asset managers who use repo only as a safe instrument. Bilateral transaction without the intervention of a third party agent allows a greater room for negotiation on a case by case basis of criteria for eligible collateral without having to refer to standardized templates issued by an agent. Furthermore, bilateral repo gives the beneficiary a direct access to securities in case of default of the counterparty without having to ask the third party agent for details of the collateral posted and it allows a quick and efficient sale if necessary. Bilateral repo in that sense is more protective and less expensive for investors.

In our opinion the best practice is to focus on the operational risks management on securities lending /repo, namely :

1. the choice of counterparties
2. the eligible collaterla matrix
3. haircuts applied to different collateral types
4. daily valuation of lent securities and collateral received on the basis of reliable market prices
5. margin calls that may be applied on a daily basis if needed

6. collateral segregation at the custodian at fund and counterparty level
7. a prudent framework regarding a potential collateral reuse.

Also, for all types of operations (with tri party or bilateral), the concern is on the lack of transparency at a Macro-level market data. In the absence of centralised securities financing markets and due to bilateral nature of securities financing transactions, the most appropriate transparency would be through a centralised post-trade reporting. This reporting, through aggregation of the different existing sources of market, would allow market participants to have a good overview before entering into a transaction and obtain a more fair value price for them and for their client. This issue is under the scope of MIFID and MIFIR in Europe.

- There are cases when investor's protection and performance would not be increased but reduced if a collateral requirement were to be introduced; in other words, a principle of appropriateness should be introduced when considering the implementation of a new regulation.

For example, many funds, called formula funds (a certain type of structured funds), offer the subscribers a performance equal to the application of a formula (with a reference to a well known market index for example); the subscribers to these formula funds already benefit from a protection from a guarantor insuring that the final performance of the fund will be equal to the formula. Therefore the collateral used to secure the investment of those funds is not a second but a third recourse security for the subscribers. The guarantor of the fund is the first to be exposed to any investment failure from the fund and in second recourse to the quality of the collateral that would have been received. Any regulation narrowing the collateral eligibility in those funds will increase their cost and make them more difficult or impossible to launch, therefore leading to the development of non guaranteed formula funds that would in the end lower investor's protection in that field. Furthermore these formula funds may have to increase their risk and use synthetic structure if they are restricted to lend their portfolio and re-use cash received as collateral for their interest rate swaps.

- Some issues which are discussed in the report are not specific to repos and securities lending; they should be considered in the appropriate framework of their specific characteristics and in light of their possible contribution to systemic risk. The following two examples will illustrate the point.

In section 5.2.1, the report underlines the risks of investing in MMF cash received as collateral of securities lending. Eventually if the lent securities fall in value, collateral will drop and shares in MMF will be sold. We believe that suggested conclusion that MMF thus participate to the systemic risk resulting from securities lending is misconceived. What other possibilities are available for the beneficiary of cash? Keep a balance in cash at the bank with a large, undiversified counterparty risk? Manage by himself the investment in CDs and other short term instruments as the MMF manager would do? Renounce and not require any collateral? All other possibilities are less efficient than investing cash in MMF.

When the report in section 5.4 describes the damage of a fire sale of collateral, it insists on the impact on illiquid assets. However, the idea of concentrating collateral on supposedly liquid assets is even more frightening. The fire sale of collateral appears when a counterparty defaults, stressing the market conditions at once. At that time confidence is no longer high and market liquidity disappears on all segments. A run towards a very limited number of high quality assets will go together with a desperate move to sell at any price assets formerly considered as sufficiently safe to be eligible collateral and turning uncertain. Concentration of collateral on a limited number of assets that may at any time be considered as non longer prime quality creates a risk of transforming a financial crisis into a sovereign debt crisis. Allowing for a large freedom in the choice of eligible collateral, together with adapted haircut (evolving gradually and not discontinuously), seems paradoxically a way to reduce systemic risk.

We would also like to point out that most of the financial stability issues described in the document are already within the scope of several European directives and regulations, such as MIFID, MIFIR, EMIR, MAD. Those directives and regulations will soon enter in force in the EU and may answer the FSB concerns. Additional recommendations/regulations may lead to a negative pro-cyclical effect for European participants.

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Sincerely Yours,

(signed)

Eric Pagniez