Comments

on the FSB's consultation on Strengthening Oversight and Regulation of Shadow Banking

Register of Interest Representatives
Identification number in the register: 52646912360-95

Contact:
Christina Wehmeier
Telephone: +49 30 20225-5336
Telefax: +49 30 20225-5325
E-Mail: Christina.Wehmeier@dsgv.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

Coordinator:
German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Telefax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

Consultation of the FSB on Strengthening Oversight and Regulation of Shadow Banking

General remarks

With the publication on 18 November 2012 of its overview of policy recommendations, consultative documents and monitoring report, the FSB has highlighted the progress made to date on regulating the shadow banking sector. Recommendations for regulating money market funds and securitisation products have already been unveiled by IOSCO. And it should not be forgotten that some legislation and regulation already in place or soon to be implemented in the EU (e.g. CRD/CRR, AIFMD, Solvency and EMIR as well as guidelines and best practice recommendations of the European Supervisory Authorities concerning securitisation and/or funds) also covers aspects of the shadow banking sector. This already existing regulatory framework will not only cover credit institutions but also, to some extent, non-banking entities (such as leasing or factoring companies). Since these entities and/or their activities are already covered by regulation addressing most, if not all of the aspects which are to be addressed by any future shadow banking regulation, there is no apparent need for a further layer of regulation.

Though important progress has already been achieved, these recent publications by the FSB indicate that there is still a long way to travel on the road towards globally compatible national implementation of the recommendations. The original timetable for regulating the shadow banking sector has already slipped. The consultation by Workstream 1 on the interaction between banks and shadow banking entities – an issue which is especially important to banks – has even been postponed until the middle of 2013. Even if the final recommendations are issued as planned at the G20 summit in St. Petersburg, the most difficult part of the project will probably not be reached until 2014, when the recommendations will have to be implemented in various countries at national level. This problem has not yet been sufficiently addressed by the FSB. Initial experience with the already published recommendations on money market funds suggests that readiness to implement recommendations at national level will be the real challenge of the project. Without internationally compatible implementation, it will probably not prove possible to improve financial stability despite the efforts and commitment of the FSB.

Progress on regulation can only be achieved if there is clarity about what needs to be regulated. Although there is evidence in the monitoring report of substantial progress in measuring the shadow banking sector, the available statistics are nowhere near a sufficient basis on which to formulate effective regulation. It is especially regrettable that the statistics available in the EU so far lack the granularity needed for a meaningful analysis of the shadow banking sector. This gap should be closed prior to taking any further regulatory steps.

The FSB has succeeded in making it clear that the shadow banking sector is an indispensable part of the financial system. Nevertheless, there remains a big discrepancy between the perceived threat emanating from the shadow banking system and the wide range of shadow banking activities described by the FSB. Policymakers should not, in their legitimate efforts to regulate this sector of the financial markets, let themselves be blinded by the huge sums arrived at if all activities are added together. An appropriate response to the challenges of regulating the shadow banking sector requires adequate account to be taken of the variety and complexity involved. In this context, accounting standards and practice may require a closer look since these may have a greater impact on market practice than regulatory measures.

In addition, it is difficult to identify any aspect discussed in the context of shadow banking which - at least in the EU - has not already been addressed by other regulatory measures. These measures will result in fundamental and far reaching changes to the existing regulatory framework. It is already highly likely that this new framework is not as coordinate and consistent as one would hope for. To add an additional layer of regulation which addresses aspects already covered by one or more new regulatory measures will increase the likelihood of conflicts and inconsistencies and might also have counterproductive effects. In this context it should also be taken into account that certain non-banking financial entities are already covered by parts of existing banking regulation and as a consequence are submitted to supervision. There is no need for addressing these companies additionally by shadow banking regulation.

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A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

Q1. Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?

Q2. Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).

The German Banking Industry Committee takes the view that the high-level policy framework represents a big step forward in regulating shadow banking entities. We consider that the FSB has taken a promising approach by resisting the temptation to tie its recommendations for action to specific legal forms of shadow banking entities. Instead, it has rightly focused on the economic functions or activities such entities carry out. We believe the economic functions have basically been correctly identified. The real challenge, however, will lie in pinpointing the systemic risk associated with these functions and then finding the right way to regulate them.

From the perspective of German banking industry, adequate regulation of shadow banking entities may be an important step towards greater financial stability and a level playing field. At the same time, the consultative document also gives some indication of the difficulties associated with this endeavour. Given the wide variety of different entities, internationally consistent regulation will doubtless not be easy to achieve. There are several reasons for this diversity. One major reason is the different economic functions themselves, which may be carried out singly or in various combinations. Then there are the different legal environments across jurisdictions, which often largely determine the scale of shadow banking activities and the intensity with which they are carried out. A further big challenge to the regulation process is posed by the scarcity of meaningful data available at present. It should not be overlooked that other market participants and the real economy can also benefit from activities carried out by entities classified as shadow banks because they function as lenders, investment opportunities or counterparties.

In this context it will be of paramount importance to prevent potential conflicts or inconsistencies with other regulatory measures already addressing or affecting aspects to be covered by potential additional regulation regarding shadow banking: At least in the EU, most if not all aspects addressed by the FSB proposals are already affected by regulatory measures, specifically the revision of the capital requirements framework (CRD/CRR), MiFID and UCITS as well as new regulatory measure such Solvency, AIFM and EMIR, as well as guidelines best practice requirements set out by the European Supervisory authorities regarding aspects as diverse as securitisation and ETF, including also securities lending and repo transactions. Furthermore, additional layers of regulation addressing these aspects from a different perspective may actually be counterproductive or result in conflicts or inconsistencies which could at least significantly reduce the effectiveness of the regulatory framework.

Q3. Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

If the indicators and information items listed in the Annex are made available by the non-bank financial institutions, supervisors should be in a position to identify the associated risk factors. We notice, however, that some of the indicators are based on assumptions used only in the regulated banking sector as things stand. One indicator of imperfect credit risk transfer, for instance, is based on risk-weighted assets. If the suggested indicators are now to be collected for non-bank financial institutions, the question arises as to whether these entities actually calculate them. It will be important to select information items that can be readily supplied by the entities in question. But this presupposes a precise idea of which entities will be affected by the recommendations.

Q4. Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

We notice that the proposed tools are the same as those used when regulating banks. The description of how they should be used in the shadow banking sector is extremely vague; the consultative document confines itself to a general outline of possible causes and effects. Effective regulation of the shadow banking sector will require analysis of the following criteria, however: First, what systemic risk emanates from the exercised function; second, how intensively the shadow banking entity carries out this function; and, third, what risks arise from the entity's links to other financial firms. Only then can a decision be made as to which policy tool will be the most appropriate.

A simple list of tools will not suffice. The proposed tools may or may not function as described in any given case. The degree of abstraction is currently such that this cannot be predicted. Owing to the broad range of shadow banking activities and the different degrees to which they are carried out, we believe the entire spectrum of policy options should be deployed, beginning with the creation of greater transparency. Account should also be taken of the extent to which each shadow banking entity is already regulated and to what extent this regulation already addresses the identified systemic risks. This applies all the more given that a term may have quite different meanings in different jurisdictions and thus have the potential to generate quite different risks. As a general principle, we would recommend a phased approach with cautious policy steps, remembering these may need subsequent adjustment.

Q5. Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers to the extent possible.

As to the general concern regarding the potential risks of counterproductive or even conflicting effects of additional layers of regulation addressing aspect which already are subject to the regulatory measures, see our comments above. In addition, the consultative document's high degree of abstraction makes it difficult at present to identify unintended consequences. But given the extremely broad definition of shadow banking on which the document is based and the fact that the proposed policy tools have largely been borrowed from the banking regulation toolkit, we see a risk of overregulating shadow banking activities, arguably also affecting regulated banks, and thus overly restricting the supply of international financial services. Any new regulatory requirements would therefore have to take into account the already existing regulatory framework, in particular regarding credit institutions, while also ensuring that the new rules adequately take into account the specifics of non-bank entities, which in many instances are not unregulated entities but subject to other regulatory requirements. This calls for a highly differentiated approach not yet sufficiently reflected in the consultative documents.

It should also be borne in mind that unintended consequences will definitely occur if national implementation of the policy framework for regulating shadow banking entities is not consistent across jurisdictions or is not compatible with banking regulation and national law, in particular contractual law, insolvency law and property law.

In both cases, we would see a clear risk of activities relocating to less onerous jurisdictions.

A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

Q1. Does this consultative document, taken together with the earlier interim report, adequately identify the financial stability risks in the securities lending and repo markets? Are there additional financial stability risks in the securities lending and repo markets that the FSB should have addressed? If so, please identify any such risks, as well as any potential recommendation(s) for the FSB's consideration.

While we agree in principle with the general initiative, we see a clear risk that a further layer of regulatory measures regarding securities lending and repo transactions may result in conflicts or inconsistencies with other regulatory measures already addressing or affecting many, if not all of the aspects to be covered by additional regulation regarding shadow banking: At least in the EU practically all elements addressed by the FSB proposals are already affected by regulatory measures, specifically the revision of the capital requirements framework (CRD/CRR), MiFID and UCITS as well as new regulatory measure such as the AIFM, Solvency and EMIR as well as regulatory measures on a secondary level, such as guidelines best practice requirements set out by the European Supervisory Authorities.

In addition some of the issues addressed in the consultative document, such as the issue of use rights, re-hypothecation and/or segregation of client assets are only indirectly related to the principle issue of securities lending or repo transactions: For example, the question whether a full title transfer of collateral posted by clients (or with a use right) is permissible or not should be addressed in the context of regulation covering the relationship between clients and financial institutions (as it is done in the EU through MiFID) and not – indirectly – in the context of rules for certain types of transactions.

In addition, the concept of "segregation" of assets depends greatly on the law involved and may be understood very differently across jurisdictions: In many jurisdictions which mainly distinguish between a full title transfer on the one hand or a security interest or pledge on the other, the idea that "segregated" client assets may somehow be used for repo or securities lending transactions is difficult to reconcile with applicable law and practice.

Finally, any regulatory initiative should not only take into account other existing regulatory initiatives but also accounting standards and practice.

Q2. Do the policy recommendations in the 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 such risks in the securities lending and repo markets? If so, please describe such mitigants and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?

Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe that would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment?

Q4. Please address any costs and benefits, as well as unintended consequences from implementing the policy recommendations in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers, to the extent possible, that would assist the FSB in carrying out a subsequent quantitative impact assessment.

The first question should of course be whether any additional regulation is actually required or whether the aspects to be covered have not already been addressed by other regulatory initiatives.

Repos and securities lending transactions are at the hub of an efficient global financial marketplace. Regulation going beyond that currently in place, particularly in the granularity outlined in the consultation document, would not only affect the shadow banking sector.

Both lines of business also play an – increasingly – important role in bank refinancing. These transactions provide liquidity and also ensure efficient pricing in money markets and capital markets. We therefore welcome the fact that the FSB recognises the important function repo and securities lending transactions play in the introduction to the consultation document to some extent. However, in this document the importance of repo securities may actually be understated.

The lessons learned by banking regulators from the financial crisis and incorporated into Basel III include rules with regard to liquidity in particular that banks can also comply with by expanding their repo and securities lending business. Also, the intended growth in importance of central counterparties in derivatives trading will significantly increase the demand for liquid securities and cash collateral. In this context we are concerned that the FSB sees this as posing an increased procyclicality risk although Basel III is geared to preventing exactly such a situation.
For banks, it is therefore quite obvious that regulation of this market segment will affect the financial market as a whole, so that banks would face additional rules.
Besides, there is the risk that other market participants involved would withdraw from the market hampering liquidity and efficient pricing.

Irrespective of this, it must be asked whether this analysis is correct and, if so, whether the repo market is a suitable tool for dampening procyclicality in the financial system. We refer in this connection to papers published by the European Repo Council in which both points are questioned.[1] The different practices regarding repo maturities and the use of central counterparties or tri-party repos and their impact on systemic risk should also be taken into account in the analysis.

On no account should regulation impair the functioning of this market segment, however. Regulation of repo and securities lending transactions that adversely affects financial market liquidity and banks'

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[1] *Shadow banking and repo*, 20 March 2012; *Haircuts and initial margins in the repo market*, 8 February 2012.

refinancing potential may endanger the objectives of banking regulation. In this area too, regulation should not be solely backward-looking based on the experience made during the financial crisis.

Q5. What is the appropriate phase-in period to implement the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks)?

The phase-in period should in no case be less than one year, starting with the date the relvant obligations become effective.

Q6. Do you agree with the information items listed in Box 1 for enhancing transparency in securities lending and repo markets? Which of the information items in Box 1 are already publicly available for all market participants, and from which sources? Would collecting or providing any of the information items listed in Box 1 present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided to replace such items.

We fully agree that increased transparency is the cornerstone of the future policy framework. The competent regulatory authorities should be able to obtain all relevant information to assess the risks and monitor developments.

However, we believe that the list of information items in section 2.2/Box 1 contains some elements the meaning or the relevancy of which is unclear in the context of repo or securities lending transactions or may not sufficiently take into account the differences between the legal framework in the different jurisdictions:

- It is not clear what type of information is to be provided under “collateral asset class” (item iii under the heading “For repo markets”).
- The information items i “principal amount” and ii “currency” under the heading “For securities lending” have no or very little practical relevancy in relation to securities lending transactions. Here, information regarding the securities involved, based on an established classification system such as ISIN, would be more appropriate.
- Likewise, the information item regarding “firm level data”, item ii “volume and value of securities available for lending” under the heading “For securities lending” is inappropriate or inconsistent with market practice or even the legal framework in many jurisdictions, as this implies that counterparties would need to distinguish between assets which potentially can and cannot be used for these transactions. This could be understood as a requirement to provide information on all collateral received from clients – not only by way of full title transfer but also by way of pledge or similar means. To require such information on all collateral received from all clients would neither be useful nor reasonable. This applies correspondingly to the information item “The way securities received by the counterparty are held, i.e. in segregated accounts or pooled accounts”: In many jurisdictions, only securities received from clients by way of full title transfer are used for these transactions.

Apart from that, the amount of information items covered in the list is too extensive. The amount of data gathered will be too great and detailed to permit efficient analysis. In addition, there may be differences in the application and interpretation of the information requirements, in particular regarding those information items requiring complex assessments and judgments on the part of the reporting party (especially taking into account the differences between legal concepts applicable across different jurisdictions). Thus, the data provided will never be able to provide a comprehensive and fully objective view.

A better approach may be a reduced list of information items concentrating on core or aggregated data which can be efficiently analysed and compared. On the basis of this key data, the regulatory authorities would be in a position to decide to require further, more specific information from market participants. Disclosure of the data at ICMA Survey level would likely be more meaningful than a collection of overly granular data that may lead to wrong conclusions.

Such an approach would also minimise the practical difficulties market participants, in particular less sophisticated market participants, will face in accumulating and providing all information items in a timely and sufficiently reliable manner.

Moreover, certain information items concern highly sensitive information, e.g. counterparty data, rates and information on positions and exposure. A reduced, less granular list would therefore also minimise the risk of potential abuses in the event of data security breaches. As regards any data made available to the public, it is of paramount importance that the identity of any party to a transaction cannot be detected through this published data. As to the need to ensure that information on the individual exposure or positions taken by any party will only be available to the competent supervisory authority, see below. Therefore, data to be made available to the public should be limited to aggregated information.

Q7. Do you agree TRs would likely be the most effective way to collect comprehensive market data for securities lending and / or repos? What is the appropriate geographical and product scope of TRs in collecting such market data?

Trade repositories are generally an effective instrument to ensure a greater degree of transparency for regulatory authorities. However, the transactions which are to be reported need to be clearly differentiated and defined.

Considering the sensitivity of the data involved, access to the data must be limited to the relevant regulatory authorities (see also response to Q6 above regarding the potential risk in case of security breaches). TRs thus need to be subject to the highest data security standards and have clear-cut rules governing access by regulatory authorities to the data.

In order to allow the greatest possible degree of transparency across the market as a whole, there should be a clear preference for limiting the overall number of TRs and/or overlaps. Consequently, there have to be robust and effective agreements ensuring access by regulatory authorities from other jurisdictions to data relevant for their regulatory purposes.

Q8. What are the issues authorities should be mindful of when undertaking feasibility studies for the establishment of TRs for repo and / or securities lending markets?

Any initiative regarding the establishment of TRs should make full use of lessons learnt from the experience of delivering trade reporting for OTC-derivatives. It needs to be ensured that counterparties can build on or use the existing technical infrastructure and information technology for reporting of repo and securities lending transactions.

Q9. Do you agree that the enhanced disclosure items listed above would be useful for market participants and authorities? Would disclosing any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be disclosed instead.

Q10. Do you agree that the reporting items listed above would be useful for investors? Would reporting any of the items listed above present any significant practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be reported instead.

In view of the sensitivity of the information involved only very generic information can be made available to other market participants. Already the knowledge that a counterparty has taken a certain position have very serious negative effects for that counterparty. It thus has to be ensured that any information available to persons other than the competent supervisory authority is generic and general only and does, in particular, not allow any insight in positions taken by specific counterparties.

Q11. Are the factors described in section 3.1.2 appropriate to capture all important considerations that should be taken into account in setting risk-based haircuts? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?

The approach ultimately chosen needs to guarantee a sufficient degree of flexibility and avoid overly uniform or rigid requirements in order to allow a risk-based approach consistent with the specific risk situation and risk management capabilities of the market participants involved. Banks should be able to rely on their own models. Therefore any minimum requirements to be set should be coordinated with existing regulatory requirements to ensure that these do not conflict or are inconsistent with models used by banks which conform to existing requirements.

The FSB proposes that supervisors introduce minimum standards for the methodologies used to calculate haircuts for repo and securities lending transactions. Haircuts are to be based on the long-run risk of collateral assets and calibrated at a high confidence level; they are also to capture other risk considerations where relevant.

This approach is only consistent with current banking practice to a limited extent. In actual fact, models play just a supporting role in calculation of haircuts. These models measure primarily counterparty creditworthiness, with asset volatility merely being taken into account on a supplementary basis. Model results serve as the basis for an expert decision. Haircuts may therefore vary considerably depending on the counterparty and asset involved. This means that the threat of procyclical behaviour should be largely averted in practice.

In particular the proposal to use the long run maximum expected decline in the market price of the collateral, calibrated at the 95% confidence level, could be problematic. As described above, historic haircuts would incorporate an assessment of counterparty risk alongside collateral price volatility and therefore using them to determine future haircuts for counterparties with very different risk profiles would make little sense. For example, in Triparty Repo (where all trades are cleared centrally and the risk of CCP default is extremely low) applying the long run worst case scenario, which may have been based on non-credit worthy counterparties, would be unsound.

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Furthermore, any institution specific ‘worst-case’ model which goes beyond the haircuts prescribed in the Basel III Liquidity Coverage Ratio (i.e. standardised haircuts based on predicted worst case price volatility) could produce significant unintended consequences.
With this in mind, it remains unclear why the FSB apparently focuses solely on the assets underlying transactions in calculation of haircuts. Procyclicality cannot be curbed in our view through such an approach.

Q12. What do you view as the main potential benefits, the likely impact on market activities, and possible unintended consequences of introducing a framework of numerical haircut floors on securities financing transactions where there is material procyclicality risk? Do the types of securities identified in Options 1 and 2 present a material procyclical risk?

Q13. Do you have a view as to which of the two approaches in section 3.1.3 (option 1 – high level – or option 2 – backstop) is more effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

Q14. Are there additional factors that should be considered in setting numerical haircut floors as set out in section 3.1.3?

Q15. In your view, how would the numerical haircut framework interact with model-based haircut practices? Also, how would the framework complement the minimum standards for haircut methodologies proposed in section 3.1.2?

Our answers to questions 12 – 17 are given subject to the reservation that a full assessment requires further in-depth analysis that we were unfortunately unable to carry out in the short time at our disposal. They should therefore be seen merely as preliminary remarks on the issues involved. In addition to these answers, we wish to comment in general as follows:

- It is difficult to see any direct connection between the models used to determine the haircuts and pro-cyclicality. As such we would not support the application of mandatory minimum haircuts.
- If minimum standards/requirements are to be set, to avoid inconsistencies and conflicts, they would need at least to be aligned with corresponding provisions under other regulatory frameworks, in particular the new capital requirements framework. Market participants’ risk management systems need to be able to rely on models and approaches consistent with the capital requirements regime, including reliance on individual models and systems (see response to Q 11).
- Overly rigid haircut requirements will have a significant impact on overall liquidity. The potentially far-reaching consequences entailed, particularly in combination with other regulatory developments, cannot be overstated. We therefore welcome it that this issue will apparently be taken into consideration.

It should also be noted that the prices of assets that are used in repo and securities lending transactions are fixed on the spot markets. Changes in the value of such assets are reflected – but not triggered – by the repo markets. Any attempt to absorb procyclicality in the financial system by introducing minimum haircuts for repos and securities lending is therefore likely to fail as long as the ‘asset price inflation’ problem remains unsolved.

Finally, it should be remembered that average repo maturities differ widely in some jurisdictions. If one accepts the pro-cyclicality argument, this point assumes more importance. It has not yet been taken into account in the FSB’s proposals, however.

The impact that minimum haircuts would have on the liquidity of repo and securities lending markets is difficult to assess. We drew attention above to the important role that repos and securities lending play in bank refinancing. Introducing minimum haircuts without a comprehensive assessment of the anticipated impact on liquidity would be irresponsible in our view. Any final recommendations in this area must fully take into account the growth in importance of repos and securities lending caused by other aspects of banking regulation.

Whilst we do not think minimum haircuts are a good idea, if this recommendation is to be developed, we see a gap in the proposal to introduce numerical floors as concerns all transactions executed through an agent without individual transactions being entered into. In this case, it would not be possible to calculate a haircut for every single security. This type of transaction would not be captured by a framework of numerical floors, and it would have to be clarified how a pre-determined haircut should be taken into account here. The consequence could be a basket adjustment by the agent in line with the supervisory haircut.

The floors proposed by the FSB for option 1 (high level approach) and option 2 (backstop level approach) are a good starting point. At the same time, categorising the relevant securities as “sovereign”, “corporate and other issuers”, and “securitised products” does not appear adequate in our view. In particular, covered bonds and – from a German perspective – the Pfandbrief are not yet included. These categories would therefore have to be modified accordingly.

Q16. In your view, what is the appropriate scope of application of a framework of numerical haircut floors by: (i) transaction type; (ii) counterparty type; and (iii) collateral type? Which of the proposed options described above (or alternative options) do you think are more effective in reducing procyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

As to our general concerns regarding the connection between pro-cyclical effects and haircuts, see above.

The scope of supervisory haircuts should be primarily by counterparty type and, additionally, by collateral type. Haircuts should be applied only to transactions by shadow banking entities with each other and with regulated financial intermediaries.

Given the need to ensure interbank market liquidity, mandatory application of haircuts in the interbank market does not appear appropriate, on the other hand. In this area, repo and securities lending transactions are already fully standardised and regulated today through the use of standardised master agreements including standardised margining rules.
It should also be borne in mind that if minimum haircuts are introduced in the interbank market there is the danger of flows of funds between banks drying up. Such haircuts would not be conducive to building trust between banks. In the interbank market, the introduction of haircuts should be made contingent upon in-house bank analyses.

Q17. Are there specific transactions or instruments for which the application of the numerical haircut floor framework may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.

We do not have enough information at our disposal to answer this question.

Q18. In your view, how should the framework be applied to transactions for which margins are set at the portfolio basis rather than an individual security basis?

Provision of margins on a portfolio reflects the fact that transactions are regularly entered into on the basis of master agreements covering the portfolio so that all transactions together form a single agreement. This allows risk management on a net basis and thus reduces risk exposure and permits more effective risk management.

This risk-reducing effect needs to be recognised by all requirements governing risk management of transactions and portfolios as well as margining.

Q19. Do you agree with the proposed minimum standards for the reinvestment of cash collateral by securities lenders, given the policy objective of limiting the liquidity and leverage risks? Are there any important considerations that the FSB should take into account?

Q20. Do you agree with the principles set out in Recommendation 9?

Q21. Do you agree with the proposed minimum standards for valuation and management of collaterals by securities lending and repo market participants? Are there any additional recommendations the FSB should consider?

We largely agree with the general approach of defining minimum standards for the treatment of collateral, including re-use because cash-reinvestment can add significantly to maturity transformation outside the banking sector. However, any final assessment necessarily depends on how these standards are eventually implemented and, in particular, the specific minimum levels, standards and limits which will be set.

It is important to be clear about the intended scope of this recommendation. Were these requirements to be applied to regulated credit institutions, there would be significant overlap with existing regulatory initiatives in this space which in turn could have negative unintended consequences.

In addition, we refer to our general comments raised in respect of the need to clearly distinguish between the transactions on the one hand and the separate issue of restrictions regarding the treatment of client assets on the other hand, which is best addressed in the context of regulation specifically covering the relationship with the client.
Furthermore, it is difficult to see a direct connection between some of the issues addressed in this context (such as cash collateral) and the practice regarding securities lending and repo transactions in many jurisdictions. These issues may be related to legal concerns which are jurisdiction specific and thus cannot be addressed in a global manner. At the very least, the differences between the relevant contractual and property law regimes need to be analysed in greater detail.

Moreover, the compound impact of all regulatory requirements affecting collateralisation has to be taken into account.

Against this background, we believe that any minimum standards should allow for a sufficient degree of flexibility permitting adjustments in view of the specific jurisdictions as well as risks involved and also provide for risk-based exemptions.

Q22. Do you agree with the policy recommendations on structural aspects of securities financing markets as described in sections 4.1 and 4.2 above?

We fully concur with the analysis under section 4.1 on advantages as well as potential drawbacks of CCPs as an instrument for efficient risk mitigation.

We fully support the decision not to include changes to bankruptcy law treatment and development of special Repo Resolution Authorities (RRAs) in the current policy framework: the proposals put forward by some academics meet with serious concerns, not only because of the significant difficulties in implementation mentioned in recommendation 13.

We also strongly believe that these proposals, in particular the idea to revoke existing legal safeguards for repo and securities lending agreements, would increase – not limit – risks and should therefore be clearly rejected.

To revoke the existing safeguards regarding insolvency law-based powers to rescind agreements or prevent their termination would undermine the close-out netting mechanism incorporated in all master agreements for repo and securities lending transactions. This mechanism is an essential feature ensuring risk reduction and effective risk mitigation. Close-out netting provisions are based on the ability to terminate and close out transactions with a counterparty in the event of insolvency. In recognition of the importance of close-out netting for risk management, this ability is protected in many jurisdictions by specific safeguards under insolvency law powers. Any revocation of these safeguards would render close-out netting ineffective or at the very least cause severe legal uncertainty.

Apparently, the revocation of safeguards and the resulting legal uncertainty for counterparties is the expressed purpose of the relevant proposals. The underlying reasoning appears to be that the increase in risk due to the inability to rely on close-out netting (or legal uncertainty) would ultimately work as a deterrent for market participants to enter into transactions. We strongly believe that this reasoning is highly questionable: risk-mitigating instruments such as close-out netting need to be strengthened and improved rather than weakened. We are also seriously concerned that these proposals apparently mean distinguishing between “riskier” and “less riskier” transactions, depending on the type of collateral involved. Any attempt to distinguish legal effectiveness of close-out netting based on qualitative criteria such as the “riskiness” of a transaction must fail and thus has to be rejected outright. Such an approach would necessarily result in severe and unacceptable legal uncertainties, not least because determining which transactions or portfolios would be affected will ultimately be arbitrary.

Instead of considering limiting existing safeguards, it should be considered to implement or extend safeguards in relation to insolvency law restrictions: In particular, it should be considered to limit any insolvency law based rights to void or set aside transactions entered into in a suspect period prior to an insolvency where these transactions conform to market standards and, in particular provide reciprocal (two-way) rights for both parties. Such a safeguard would ensure that counterparties with financial difficulties continue to be able to find counterparties willing to enter into transactions in order to secure their continued liquidity. Without such safeguards, the risk that these transactions are later voided or set aside work as a strong disincentive to potential counterparties to continue transactions with a counterparty which may face financial difficulties and thus escalate the situation.