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Submitted by email to fsb@bis.org

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

14 January 2013

RE: FSB Consultation on a Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

Dear Sir/madam,

ICI Global appreciates the opportunity to provide comments on the Financial Stability Board's (FSB) consultative document setting out a proposed policy framework for addressing shadow banking risks in securities lending and repos (referred to hereinafter as "the Consultation").[1] ICI Global has previously provided comments[2] on the interim report of the FSB Workstream on Securities Lending and Repo (referred to hereinafter as "the Interim Report").[3]

ICI Global is a trade organisation focused on regulatory, market and other issues for global investment funds and their managers. ICI Global Members include regulated investment funds that are publicly offered to investors in jurisdictions worldwide, collectively representing total assets of over $US1trn.

The Consultation raises a number of important issues for ICI Global Members[4] and their investors, both of whom have a strong interest in the FSB's work to identify and investigate potential causes of systemic risk arising from the secured finance market.[5] ICI Global, in conjunction with the Investment Company Institute (ICI)[6], has been deeply engaged in the work that has been undertaken by the FSB into shadow banking over the last couple of years.

In its comment letter in response to the Report, the ICI has addressed the Consultation from the perspective of U.S. registered investment companies that participate in the securities lending and repo markets.[7] ICI Global is pleased to comment in this letter on those issues to the global secured finance market, particularly as these issues relate to publicly available, regulated funds.[8]

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[1] Consultative Document, Strengthening Oversight and Regulation of Shadow Banking, A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Financial Stability Board, 18 November 2012 (available at http://www.financialstabilityboard.org/publications/r_121118b.pdf).

[2] Letter from Dan Waters, Managing Director – ICI Global to the Secretariat of the Financial Stability Board re: FSB Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues, dated 25 May 2012 (available from http://www.financialstabilityboard.org/publications/c_120806g.pdf)

[3] Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report of the FSB Workstream on Securities Lending and Repos (available at http://www.financialstabilityboard.org/publications/r_120427.pdf)

[4] References in this letter to "ICI Global Members" refer, as relevant, to the management companies, investment advisers and/or the funds themselves that ICI Global represents.

[5] The "secured finance market" is a term used in this letter to collectively describe the market for securities lending transactions and repurchase ("repo") transactions as categorised in the Report.

[6] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.9 trillion and serve over 90 million shareholders.

[7] Letter from Robert Grohowski, Senior Counsel to the Secretariat of the Financial Stability Board re: Addressing Shadow Banking Risks in Securities Lending and Repos, dated 14 January 2013

[8] References to "publicly available, regulated funds" in this letter refer to those funds that as a general matter are available for sale to the general public under an authorisation, licensing or other regulatory regime administered in their own domestic or regional jurisdiction.

General Remarks

In the subsequent sections of this letter we have set out our detailed comments on aspects of the Consultation. Below we provide a number of general remarks.

- We support the FSB's[9] stated objective of ensuring that supervisory authorities[10] can identify, monitor and mitigate risks to financial stability. As is acknowledged in the Consultation, the secured finance market provides significant utility to the financial markets and financial institutions and the FSB should balance the benefits of this activity with the management of the risks about which it is concerned.

- Although the securities lending and repo markets are both categories of secured finance, they are distinct and fundamentally different in nature. While some of the recommendations outlined in the FSB Consultation apply to both markets, others require tailoring to reflect the different types of transactions to which they relate. As such, the FSB must clearly distinguish securities lending from repos in making its final recommendations.

- As we set out in our comment letter in response to the Interim Report, we strongly encourage the FSB to consider carefully the fundamental regional and jurisdictions differences that exist across markets and furthermore to take account of the existing regulatory requirements that are in place or under reform in these jurisdictions. There are some aspects of commonality in respect of which the FSB should ensure to the greatest extent possible that regulatory frameworks are coordinated at international level. We believe however that it is neither practical nor desirable to adopt a one-size-fits-all approach to the regulation of many aspects of the global secured finance market.

International Context

The FSB's work in the context of secured finance is being pursued against the backdrop of various regional and national initiatives that concern similar and/or related issues. The European Commission (EC) has included securities lending and repo within the scope of possible shadow banking activities on which it is currently focusing its analysis[11] and it referenced the activity in a recent consultation on reforms to the UCITS framework.[12] The EC has also indicated its intention to bring forward legislative proposals in this area.[13]

The European Securities and Markets Authority (ESMA) has recently published two sets of guidelines for UCITS funds engaging securities lending transactions[14] and entering into repo and reverse repo agreements.[15] As is set out in the comment letter submitted by the ICI in response to the Consultation, in the U.S. the Dodd-Frank Act[16] has directed the U.S. Securities and Exchange Commission (SEC) to propose rules to enhance transparency measures related to securities lending.

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[9] References to the FSB and Workstream 5 (WS5) on Securities Lending and Repos are used interchangeably in this letter

[10] References to "supervisory authorities" in this letter refer as relevant to those public authorities including central banks, securities regulators and authorities with explicit financial stability oversight objectives.

[11] p4, Green Paper on Shadow Banking, European Commission, 19 March 2012 (available from http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf)

[12] Consultation on UCITS Product Rules, Liquidity Management, Depositary, Money Market Fund and Long-term investments, 26 July 2012 (available from http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf)

[13] European Commission Roadmap "Follow up to the Green Paper on Shadow Banking – Addressing systemic risks related to shadow banking", 10/2012 (available from http://ec.europa.eu/governance/impact/planned_ia/docs/2013_markt_017_initiative_on_shadow_banking.pdf)

[14] See relevant sections covering "Efficient Portfolio Management" techniques in Guidelines on ETFs and other UCITS issues, ESMA, 18 December 2012 (available from http://www.esma.europa.eu/system/files/esma_en_0.pdf)

[15] Final Report, Guidelines on repurchase and reverse repurchase agreements, ESMA, 4 December 2012 (available from http://www.esma.europa.eu/system/files/2012-722.pdf)

[16] Dodd Frank Wall Street Reform and Consumer Protection Act

Financial stability risks in securities lending and repo markets

As we set out in out comment letter in response to the Interim Report, we consider the secured finance market to provide significant utility to investment funds. Also, as is acknowledged briefly in the Consultation, and supported by numerous studies[17], the secured finance market also plays an important role in promoting market efficiency including by enhancing price-discovery and secondary market liquidity. We consider that the FSB should acknowledge further the benefits of securities lending and repo transactions to ensure it balances these benefits with the measures it is proposing to manage the risks about which it has concerns.

Securities lending and repos are two of a range of investment techniques used by regulated publicly available investment funds in an effort to enhance the risk and returns profile of the portfolios under their management, for the benefit of their investors. In some jurisdictions such as the EU, such transactions can be defined as constituting techniques for the purpose of efficient portfolio management.[18]

Although both securities lending and repo are categories of secured finance, various studies and regulatory papers have noted that they are distinct and fundamentally different in nature.[19] Indeed, as was noted in the comment letter we submitted in response to the Interim Report and acknowledged in the Report itself, there are considerable variations between the different categories of secured finance markets that exist across jurisdictions. Most notably this includes those variations that exist on a regional basis between the U.S. and Europe, and in turn the key jurisdictions in Asia Pacific. In many cases, fundamental differences exist between the legal basis under which transactions are completed (e.g. the nature of the "lending" arrangement for securities between the U.S. and Europe), and the infrastructure and form of transactions (e.g. the prevalence of tri-party repo structures in the U.S.).

The FSB should take account of these differences and the considerable regulatory frameworks that already govern the secured finance market in the major jurisdictions in which fund managers engage in such transactions. As we set out in our comment letter in response to the EU Commission's Shadow Banking Green Paper and in other comments we have made, we do not consider securities lending and repo activities to constitute shadow banking.[20] Investment funds engaging in securities lending and repo transactions do so for the benefit of their investors and not, as has been suggested by some commentators, to build shadow banks.[21] It is not the case, as is asserted in the Consultation, that "whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements." As we have clearly described in our subsequent comments, securities lending and repo transactions are governed by a strong framework of regulation. This framework of regulation places strict limits on the use of leverage by regulated publicly available investment funds – and in some case this is entirely prohibited – and other restrictions that limit the extent of any liquidity transformation or maturity transformation performed by funds.

Policy recommendations related to improvement in transparency

The Consultation sets out a number of policy recommendations that seek to improve transparency in the securities lending and repo markets. The chapeau to Section 2 of the Consultation refers explicitly to enhancements in regulatory reporting and the onward public disclosure of this data, as was discussed in the Interim Report.

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[17] Various studies have examined the benefits of securities lending and repo http://www.bankofcanada.ca/wp-content/uploads/2011/12/fsr-0610-dreff.pdf

[18] Article 11 of COMMISSION DIRECTIVE 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions (commonly known as the "Eligible Assets Directive") defines techniques and instruments for the purpose of efficient portfolio management (available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF)

[19] The differences in the nature of transactions is acknowledged in Securities Lending Transactions: Market Development and Implications, July 1999 (available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD96.pdf)

[20] http://ec.europa.eu/internal_market/consultations/2012/shadow/individual-others/ici-global_en.pdf

[21] Shadow Banking: Thoughts for a Possible Policy Agenda, Speech by Paul Tucker at European Commission High Level Conference on Shadow Banking, 27 April 2012 (available from http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech566.pdf)

The Consultation however goes further, setting out recommendations concerning the direct reporting of data to the market and to end-investors by counterparties engaged in securities lending and repo transactions.

We have set out comments on these recommendations grouped into three areas below.

Improvements in regulatory reporting and market transparency

Box 1 of the Consultation recommends a wide-ranging set of quantitative data to be collected by supervisors. Furthermore it recommends that "*more granular data on securities lending and repo exposures among large international financial institutions is collected with high urgency*" and references the existing work of the FSB Data Gaps Initiative in this regard.[22]

As a general comment, we consider that supervisors should have the information they require to identify, monitor and manage potential systemic risks to financial stability arising from securities lending and repo transactions. We therefore support the overarching premise of this recommendation but, as we have set out below, we have concerns over the proposed dataset and the method for collecting this data under Recommendations 2 and 3 in the Consultation.

As we set out in our comment letter in response to the Interim Report, requiring micro-level data such as the transparency of individual counterparties and/or program risks in real-time, or the reporting of transactions by individual market participants, would not appear to provide a cost effective framework through which systemic risks could be monitored. Instead, in gathering data the FSB should recommend that supervisors only seek to obtain the information they need and to endeavour to collect this information in the most efficient way reasonably available.

Box 2 of the Consultation examines the various methods through which data could be collected from institutions involved in the secured finance market. The proposed framework appears heavily biased towards a framework characterised by the standardised periodic collection of a considerable set of quantitative data either through the reporting of information to national or regional supervisors or to trade repositories (TRs).

Furthermore, while Box 2 of the Consultation proposes that the additional information proposed by the FSB could be collected under a regulatory reporting framework through "amendments to existing reports", no analysis is presented in the Consultation as to the adequacy of this existing framework of reporting. The framework proposed by the FSB appears to go far beyond any reporting framework currently in existence and would represent a significant change for regulators and market participants.

We would strongly urge the FSB in the first instance to consider the adequacy of the existing frameworks of regulatory reporting, many of which have been considerably strengthened since the financial crisis. In Europe for instance, as has been acknowledged in a recent report by IOSCO,[23] legislation under the Alternative Investment Fund Managers Directive (AIFMD) requires reporting of repo trades on a periodic basis by certain fund managers.[24] Similar initiatives have been put in place in other jurisdictions including the U.S., as is set out in detail in the ICI's comment letter. Furthermore, IOSCO[25] has undertaken recent work to examine the role of securities regulators in mitigating systemic risk, in which it proposes that a framework of potential indicators to specific sources of systemic risk in the securities markets including elements related to securities lending and repo.

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[22] The FSB Data Gaps Initiative's first report was to G20 Finance Ministers and Central Bank Governors, Prepared by the IMF Staff and the FSB Secretariat, 29 October 2009 (available from http://www.financialstabilityboard.org/publications/r_091107e.pdf)

[23] Mitigating Systemic Risk, A Role for Securities Regulators, Discussion Paper, February 2011 (available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf)

[24] Q2, Q14(d) and Q26 of Annex IV of Commission Delegated Regulation of 19/12/2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (available from http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf)

[25] Discussion Paper on Mitigating Systemic Risk, A role for Securities Regulators, IOSCO, February 2011 (available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf)

IOSCO has also specified data to be collected at international level in respect of hedge funds,[26] including information on repo trades, given the significance of such funds as users of repo for the facilitation of hedge fund strategies involving leverage and short selling.[27]

As well as considering the adequacy of the existing frameworks of regulatory reporting as outlined above, we consider that the FSB should give further thought to the method through which such data would be collected. The references in the Consultation to the FSB's Data Gaps Initiative – which has hitherto predominately focused on banks – may not be particularly helpful when considering the collection of data from other entities such as fund managers. In this regard it is worth acknowledging the work undertaken by the Bank for International Settlement's Committee on the Global Financial System (CGFS)[28] concerning the role of margin requirements and haircuts in procyclicality.[29]

The CGFS's report explicitly recommends[30] that "*macroprudential authorities to assess financing conditions in secured lending … markets, consider the value of regularly conducting and disseminating a predominantly qualitative survey of credit terms used in these markets, including haircuts, initial margins, eligible pools of collateral assets, maturities and other terms of financing*." This recommendation is proposed to address "*the significant obstacles, including the high dimensionality and proprietary nature of credit terms, that would arise in conducting a quantitative survey*".

We request that the FSB consider the value in the various other approaches that are available for the collection of data including those along the lines of that suggested by the CGFS.

As noted previously, we support a framework under which supervisors have the information they require to identify, monitor and manage potential systemic risks to financial stability arising from securities lending and repo transactions. We consider it a step too far, however, to suggest that the economic terms of securities lending transactions be disclosed to the public. The parties to securities loans negotiate their economic terms taking into account a myriad of factors, including the nature of the security, the anticipated return on reinvested collateral, the identity of the borrower, the relationship between the borrower and lender, the relationship between the lender and its agent, and current market conditions. No single piece of this data set is particularly meaningful without the others.

As a result, releasing an aggregate figure or set of figures will convey very little meaningful information, and ultimately may prove more confusing than informative. Moreover, even if it were possible to disclose aggregated data on these terms in a meaningful way, it is difficult to see how such disclosure would be necessary to mitigate (or effective in mitigating) systemic risks given that regulators would have access to a more comprehensive data set through the regulatory reporting channels. Accordingly, we request that the FSB's final recommendation on market transparency for securities lending not include items such as securities lending fees or rates and breakdowns of fees and cash investment returns for the reasons we have set out above.[31]

[26] IOSCO publishes updated systemic risk data requirements for hedge funds, 22 March 2012 (available from http://www.iosco.org/news/pdf/IOSCONEWS229.pdf)

[27] Section 3.2 of the Interim Report

[28] The Committee on the Global Financial System, reconstituted in 1999, has a mandate to identify and assess potential sources of stress in global financial markets, to further the understanding of the structural underpinnings of financial markets, and to promote improvements to the functioning and stability of these markets (http://www.bis.org/cgfs/index.htm)

[29] Section 4.6 of CGFS Papers No 36, The role of margin requirements and haircuts in procyclicality, March 2010 (available from http://www.bis.org/publ/cgfs36.pdf) (referred to hereafter as "the CGFS Report")

[30] Section 4.6 of the CGFS Report

[31] We recognize that the Consultation merely includes "lending rates" in its list of aggregate data to be published (see page 7), and that this differs from the "securities lending fee or rate, including breakdown of fee and cash investment return" proposed to be collected via a trade repository (see page 6). The FSB should clarify its use of the term "lending rates" in this context.

Improvements in corporate disclosure

The Consultation recommends a reporting framework for fund managers to end-investors that comprises a broad set of quantitative data concerning securities lending and repo transactions. This recommendation is based on an assertion that the FSB considers that existing information *"falls well short of what regulators would ideally need to monitor the build-up of systemic risk in normal times and track its transmission between firms during a stress event"*.

As we have set out in our earlier comments, we consider that supervisors should have the information they require to identify, monitor and manage potential systemic risks to financial stability arising from securities lending and repo transactions. As such, while we have commented above on the method through which that data is collected, we support the overarching premise of the reporting of additional information to regulators. Although the Consultation asserts that existing regulatory reporting falls well short of what is considered necessary, it does not present any further details as to the reports that have been analysed or the particular areas of concern or shortfall. Indeed, whilst the Interim Report raised the question of whether corporate disclosure could be improved and listed some of the items of data included in financial reporting[32], no analysis was presented in that document as to the adequacy or failings of such arrangements.

As we have discussed below, it appears to us that the Consultation confuses the concept of regulatory reporting with the disclosure of corporate information to the public market.[33] As a starting point, we consider corporate disclosures coupled with point-of-sale and periodic reporting by fund managers as important tools through which the information needs of investors are served. Regulatory reports on the other hand serve the needs of supervisors in discharging their obligations; including identifying, monitoring and managing the risks posed by the fund to the wider financial system. We consider that in respect of the latter, the FSB has an important role to play to ensure an appropriate level of global co-ordination in the approach that is adopted.

The former on the other hand should be left to the existing and well established domain of national and regional accounting standard setters and, as has been discussed at length by IOSCO, to relevant securities regulators.[34]

The confusion between regulatory reporting and corporate disclosure presented in the Consultation is particularly unhelpful. It furthermore creates a significant risk of overlap in reporting – whereby duplicate information is reported in regulatory reports and corporate disclosures, resulting in additional cost for all parties involved.

Improvements in reporting by fund managers to end-investors

Section 2.4 of the Consultation asserts that "*securities lending and repos are used extensively by fund managers*" and furthermore that such transactions "*allow fund managers to access leverage on their client's portfolios*". As such the Consultation asserts that "*appropriate information on such activities needs to be frequently disclosed by fund managers to investors in order to allow those investors to select their investments with due consideration of the risks taken by fund managers*".

As we noted in our comments[35] in response to the Interim Report, not all investment funds engage in transactions in the secured finance market. In many cases regulatory regimes may prohibit or limit such activities, in other cases funds may not have the necessary types of securities to repurchase, lend or post as collateral. Furthermore, in many instances, secured finance transactions may not be appropriate to the techniques or strategies through which the portfolio of the fund's assets is being managed. It is therefore not appropriate to generalise when referring to the use or prevalence of such activities.

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[32] Section 5.1 (iii) of the Interim Report

[33] The Consultation includes within the category of corporate disclosures financial statements or Pillar 3 reports as required under the Basel framework

[34] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf

[35] Letter from Dan Waters, Managing Director – ICI Global to the Secretariat of the Financial Stability Board re: FSB Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues, dated 25 May 2012 (available from http://www.financialstabilityboard.org/publications/c_120806g.pdf)

As we have also previously noted, some ICI Global Members engage in some "leveraged investment fund financing" as described in the second market segment of the Interim Report and repo financing as described in the fourth market segment of the Interim Report. Such financing is however usually limited, or in some cases prohibited, by the various regulatory regimes under which ICI Global Members operate. Furthermore, in all cases, ICI Global Members only engage in such financing to the extent that it supports the delivery of the investment objectives and is consistent with applicable law and the investment fund's governing constitution. Again, it is not appropriate to generalise when referring to the use or prevalence of financing activities.

The Consultation asserts that fund managers engagement in securities lending and repo warrants frequent disclosure by fund managers to investors in order to allow those investors to select their investments with due consideration of the risks taken by fund managers. As a general matter, we support investors having the information they need to assess the fully disclosed risks that are taken by fund managers. We do not however see a strong nexus between this investor protection objective and the stated objective of this workstream of the FSB to address the financial stability risks in securities lending and repo markets as described in the Consultation.

Furthermore, securities lending and repo markets and the regulation of fund managers and the investment funds which engage in such markets varies markedly across different regions and jurisdictions of the world.

We consider it appropriate that matters relating to investor protection, including the disclosure of the information provided to investors to allow them to assess the risks taken by fund managers, should be addressed by regional and/or national regulators. Such an approach allows such regulators to tailor the nature of disclosure based on a number of factors including the broad financial capability of investors (based in some cases on a categorisation system) and importantly the extent to which investment funds engage in securities lending and repo transactions.

We consider that the substance, frequency and relative prominence of disclosure on any given topic should be commensurate to the materiality of the information to investors, including the impact and relevance to the risk and return profile of the fund. While fund managers should be required to disclose information necessary to allow investors to select investments with due consideration of the risks taken by the fund, policy decisions about disclosure should be left to the determination of national and regional regulators.

It is indeed already the case that a strong framework of disclosure to investors exists in all of the main jurisdictions in which regulated investment funds operate. In Europe for instance, UCITS funds are required to disclose details of the categories of securities lending and repo transactions and the resulting commitments of such transactions in periodic reports to investors.[36] In Hong Kong, Unit Trusts and Mutual Funds are required to disclose information in a fund's offering documents concerning the distribution of income from secured finance transactions, counterparty selection, collateral management and the maximum level of the fund's assets available for such transactions.[37]

[36] Annex I, Schedule B of Directive 2009/65/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) requires UCITS Funds to disclose "*Details, by category of transaction within the meaning of Article 51 carried out by the UCITS during the reference period, of the resulting amount of commitments". Paragraph 3 of Article 51 of that Directive includes "*techniques and instruments are used for the purpose of efficient portfolio management" and Paragraph 35 of Guidelines on ETFs and other UCITS issues, ESMA, 18 December 2012 (available from http://www.esma.europa.eu/system/files/esma_en_0.pdf) sets out the information that should be included in the annual report of UCITS funds engaging in efficient portfolio management techniques.

[37] Q21, Code of Unit Trusts and Mutual Funds, Securities and Futures Commission (available from http://www.sfc.hk/web/EN/faqs/product-authorization/code-of-unit-trusts-and-mutual-funds.html#25)

Policy recommendations related to regulation

Minimum Haircuts on Repos

Section 3.1 of the Consultation recommends that a prescribed methodology, based broadly on the historical volatility of collateral, is used to calculate haircuts on secured finance transactions. Furthermore, Section 3.1.4 of the Consultation recommends that numerical floors to such haircuts are applied to secured finance transactions where the primary motive is financing, as is the case for many repo transactions. As we have set out below, we believe the Recommendations in this section of the Consultation are misguided, particularly those concerning fixed or minimum haircuts.

We fundamentally disagree with the regulation of the negotiated terms of market transactions such as repos. As is outlined in detail in the ICI's comment letter, there is no historical evidence to support the Workstream's presupposition that haircuts are subject to pro-cyclical trends, at least in the U.S. tri-party repo market, and we have serious concerns that the recommended methodology for calculating haircuts would introduce systemic risk into the system rather than reduce it.[38]

Attempts to regulate the negotiated terms of market transactions ignore the fundamental role of counterparty risk management and in some instance may act contrary to it. As was outlined in our comment letter in response to the Interim Report, a significant factor for ICI Global members in managing the risk arising from secured finance transactions is the creditworthiness of counterparties. ICI Global members undertake due diligence on counterparties before engaging in secured finance transactions including assessing and specifying the quality of collateral that counterparties provide.

We consider that imposing minimum floors for collateral haircuts may also distort the market by creating a bias against forms of secured finance such as repos and in favour of more complex and less efficient forms of finance. The potential for distortions is in part acknowledged in the Consultation as one of the problems that would result from the introduction of minimum floors. We consider that this could arise in a number of different scenarios under which creditors were precluded from providing finance in the most efficient and beneficial manner through a form of secured finance.

For most categories of collateral, the proposed floors recommended in the Consultation are much higher than the haircuts currently prevailing in the market. No explanation or justification is offered for this substantial divergence from current market practice, nor is evidence offered that current levels are inadequate. The FSB has also not presented any analysis or assessment of the likely impact of imposing an increase in haircuts, which prima facie would appear be a dramatic reduction in the volume of secured finance transactions. Furthermore, as the FSB has acknowledged in the Consultation, there are numerous challenges associated with the introduction of minimum floors.[39]

For the reasons above, we consider that limiting the market's ability to set the terms of repos, including haircuts, would be a counterproductive policy. As such we urge the FSB to reconsider its approach in developing its final policy recommendations.

Cash collateral reinvestment

Cash collateral reinvestment is relevant to securities lending transactions. As was outlined in Section 1.1 of the Interim Report, cash collateral is reinvested by or on behalf of fund managers with the objective of generating an investment return sufficient to meet the "rebate" that is paid to the borrower of securities by the lender to cover the "interest" cost of the cash collateral that has been posted.

[38] The ICI's Comment Letter expresses concern that requiring buyers to base their collateral requirements solely on the historical volatility of the collateral, without regard for the financial strength of the seller, could create as buyers would uniformly increase their haircuts for that collateral, reducing the financing available for the collateral and thereby increasing the risk of carrying the collateral. The resulting reduction in market liquidity would increase the volatility of the collateral, leading to further increases in haircut requirements.

[39] p14, Consultation

As we noted in our comment letter in response to the Interim Report, fund managers often make extensive use of vehicles such as money market funds or other investment funds which have similar standards for reinvestment purposes. In many jurisdictions, regulatory regimes specify criteria or principles which must be followed when reinvesting collateral, as is the case for instance in respect of UCITS funds in Europe.[40]

We consider the recommendations put forward by the FSB as broadly consistent with the regulatory regimes and market practice for cash collateral reinvestment in existence in many jurisdictions worldwide. As was also noted in the ICI's comment letter however, we request that the FSB's final recommendations in respect of principle 1.2 on page 20 of the Consultation be clarified to permit a reasonable rate of return to be sought by fund managers when reinvesting cash collateral with the objective of preserving capital.

Minimum regulatory standards for collateral valuation and management

Section 3.4 of the Consultation sets out a number of proposed principles concerning the acceptance of collateral, the development of contingency plans for use in times of market stress and the standard for marking to market collateral and lent securities.

As noted in our response to the Interim Report, there is considerable variation between the secured finance markets in different jurisdictions. Most notably this includes those variations that exist on a regional basis between the U.S. and Europe, and in turn the key jurisdictions in Asia Pacific, particularly in respect of the legal basis under which transactions are completed (e.g. the nature of the "lending" arrangement for securities between the U.S. and Europe) and the infrastructure and form of transactions (e.g. the prevalence of tri-party repo structures in the U.S.).

As is set out in the ICI's comment letter, market forces have driven significant enhancements to collateral management practices in the U.S., including in the context of enhancements to the infrastructure supporting the tri-party repo system. In Europe, a combination of guidelines and existing regulatory frameworks address a number of the areas outlined by the FSB[41]. As such we question whether it is necessary for the FSB to make recommendations in this area.

Paragraph 1 of Section 3.4 of the Consultation states that securities lending and repo market participants should only take collateral types that they are able to hold outright without breaching laws or regulations. The impetus for this principle appears to be a concern that collateral takers are driven to sell collateral after a default in order to comply with legal requirements, rather than being motivated by economic concerns. We consider this to be a mistaken premise that is at odds with the fundamental nature of any form of secured finance transaction.

From an economic perspective, buyers in repo transactions expect the transaction to ultimately conclude with the repurchase of the collateral by the seller. Buyers do not enter into such transactions with the intent of holding the underlying collateral. In the event of default, buyers expect to sell the collateral in a manner that minimises their exposure to market risks, even in cases when permitted by laws and regulations to hold the collateral.

Economic concerns are therefore typically the proximate factor driving the rapid disposal of repo collateral rather than legal concerns. From a legal and regulatory perspective, provision is made in various regional and national frameworks for scenarios under which collateral is to be disposed in the event of a repo counterparty's default.

[40] Paragraph 43(j) of the Guidelines on ETFs and other UCITS issues, ESMA, 18 December 2012 (available from http://www.esma.europa.eu/system/files/esma_en_0.pdf) sets out applicable to the investment of cash collateral received by UCITS funds using efficient portfolio management techniques.

[41] Paragraph 43 of the Guidelines on ETFs and other UCITS issues, ESMA, 18 December 2012 (available from http://www.esma.europa.eu/system/files/esma_en_0.pdf) addresses the question of valuation, liquidity and risk management for UCITS fund engaging in efficient portfolio management techniques.

In the EU for instance guidelines set out by ESMA concerning efficient portfolio management techniques[42] and the common definition of a "European Money Market Fund" require management companies to "*immediately assess how best to bring the fund back into compliance with the guidelines*" and furthermore "*take remedial action as soon as reasonably practicable, taking into account the best interests of the investors at all times*" in such scenarios.[43] As is set out in the ICI's comment letter similar provisions also exist in the U.S.

Neither regulatory framework requires a forced "fire sale" of collateral in the event of a counterparty's default but instead requires some form of remedial action to be taken in a time-bound manner with due consideration of the interests of investors. Such provisions are expressly intended to promote an orderly disposal of collateral taking account of a myriad of factors including the underlying investment objectives and risk/return profile of the fund in question as well as market conditions. In some scenarios, the economic and regulatory requirement to act in the best interest of the investors in the fund may warrant the rapid disposal of collateral whereas in other instances this requirement may mandate that collateral is held and disposed of over a longer period.

The proposed recommendation might be interpreted to restrict repo buyers only to collateral that they could have purchased outright and held indefinitely for investment. We do not believe this was the intent, and we recommend therefore that the final FSB recommendation on collateral management not limit repo market participants to collateral that they are able to hold outright following a counterparty failure (i.e., that the FSB strike the clause in section 3.4(1)(i) of the Consultation). We consider that the resulting recommendation would more clearly reflect the fundamental nature of a repo, where collateral is not the driving component of the investment decision. It would also better reflect the fundamental role of fund managers as agents and fiduciaries, whilst also not unduly restricting the market.

Policy recommendations related to structural aspects of the securities financing markets

Section 4 of the Consultation raises a number of important questions concerning the structural aspects of the secured finance market, namely the central clearing of transactions and the treatment of transactions under bankruptcy law. We have not commented in detail on these aspects as the recommendations put forward in one case proposes that further evaluation and analysis is undertaken and in the other that reforms are not prioritised. We have instead set out a few high level comments below.

Central clearing

As acknowledged in the Interim Report, penetration of CCPs in the securities lending market has hitherto been very limited, in part because of the additional cost for lenders to use a CCP. Even in the inter-dealer repo market where the use of CCPs is far more prevalent, there are considerable regional and national variations.[44]

The incentives and drawbacks of the use of CCPs are discussed at a high level in the Consultation. We concur with the FSB's analysis in this regard that in some markets the pros and cons are more broadly balanced than in others, in part because of the market structure and the institutional specific set-up. We note the backdrop of considerable change in market structure in major jurisdictions that is underway, including to the role and prevalence of CCPs in other markets such as OTC derivatives. The impact of these changes on the securities lending and repo market, including the extent to which there will be knock on changes in the demand for "collateral mining", as discussed in the Interim Report, are as yet unknown.

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[42] Paragraph 43(h) of the Guidelines on ETFs and other UCITS issues, ESMA, 18 December 2012 (available from http://www.esma.europa.eu/system/files/esma_en_0.pdf) addresses the question of valuation, liquidity and risk management for UCITS fund engaging in efficient portfolio management techniques.

[43] Q16 of ESMA Questions and Answers "A Common Definition of European Money Market Funds" requires the management company to "immediately assess how best to bring the fund back into compliance with the guidelines. It should take remedial action as soon as reasonably practicable, taking into account the best interests of the investors at all times" (available from http://www.esma.europa.eu/system/files/2012-113.pdf)

[44] p28, Interim Report.

Against this backdrop we concur that it may not be desirable to encourage the use of CCPs in all jurisdictions. If further analysis of the costs and benefits of introducing CCPs is to be undertaken, this should only be at a point when the impact of the current structural changes in various markets can be evaluated.

Changes to bankruptcy law treatment of repo and securities lending transactions

Section 4.2 of the Consultation outlines, at a high-level, the position of repo transactions under bankruptcy law in certain jurisdiction. It goes on to acknowledge recent academic work in this area along with some of the proposed reforms.

Bankruptcy law is a complex area and one which varies considerably across jurisdictions. To a large degree this variation is as a result of fundamental differences in the systems of law under which jurisdictions operate and to underlying differences in the structure of markets. Aspects of bankruptcy are also strongly related to questions of asset segregation and custody and in respect of proposals to create a Repo Resolution Authority (RRA) the recovery and resolution of failed institutions. In some jurisdictions, including the EU and the U.S., many of these areas are already subject to reform or have been reformed subsequent to the financial crisis. Furthermore, the FSB is also undertaking its own work into recovery and resolution planning.[45]

Against this backdrop of reform and the considerable differences in law that exist across jurisdictions, we agree with the FSB that wholesale changes to bankruptcy law treatment and the development of RRA should not be prioritised. Any further consideration of this topic should be undertaken at a point at which the impact of the reforms currently in train can be fully analysed.

We appreciate the opportunity to provide comments on the Consultation. If you have any questions about our comments or would like additional information please contact me (dan.waters@ici.org or +44 203 009 3101) or Giles Swan, Director of Global Funds Policy (giles.swan@ici.org or +44 203 009 3103).

Yours faithfully,

/s/

Dan Waters
Managing Director – ICI Global

[45] Recovery and Resolution Planning: Making the Key Attributes Requirements Operational, Consultative Document, November 2012 (available from http://www.financialstabilityboard.org/publications/r_121102.pdf)