Position Paper

Insurance Europe response to FSB consultation on a policy framework for addressing shadow banking risks

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Comments on FSB consultation: "A policy framework for strengthening oversight and regulation of shadow banking entities" (Work Stream 3)

General comments

Insurance Europe generally supports the FSB's work on shadow banking, and more specifically its intention to identify the potential risk posed by leverage and maturity transformation undertaken by financial institutions outside the banking system, in particular where those activities are vulnerable to bank-like runs or contagion risks.

As indicated in our response to the IAIS consultation on systemic risk, Insurance Europe largely concurs with the FSB assessment of the characteristics of activities identified under work-stream 3 (WS3), namely maturity and liquidity transformation, which have the potential to generate systemic risk. In this respect we would hope that the assessment and review stage of the process would incorporate not only shadow banking measures but all sectoral work streams which have been initiated by the FSB.

Such an approach based on a holistic review process of all systemic risk-related work streams could identify the extent to which risks captured under one work stream mitigate those identified within a stream with an alternative focus. In this respect, an activity whose potential for systemic risk is mitigated through a shadow banking work stream should not be considered as a potential source of systemic risk under other, more sector-specific, systemic risk-related work streams. This would assist in ensuring that the unnecessary duplication of regulation across both financial sectors and activities is avoided.

Process

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Insurance Europe welcomes the five general principles set out for regulatory measures, i.e. that they should be focussed, proportionate, forward looking and adaptable, effective, and subject to regular assessment and review.

Insurance Europe supports a framework which works towards identifying the economic function being performed by the shadow banking entity or activity. However an assessment of whether the activity or entity providing the economic function is subject to existing prudential regulation, banking or not, should also be included as part of the process.

Activities

Insurance Europe specifically welcomes the FSB statement that there is a need for a differentiated application of the proposed policy toolkit to securitisation. In this respect, the differences between bank-based securitisation and those undertaken by (re)insurers should be taken into account in the design of any future framework.

It is our understanding that financial guarantee insurance which facilitates credit creation is largely undertaken by entities that are not regulated as insurers. Insurance Europe will not comment on possible measures applicable to such entities. However, we largely concur with the consultation's finding that if entities wish to undertake activities with insurance-like features then they should be subject to insurance-based prudential regulation.

With regard to the application of the proposed measures to mortgage credit insurance, we would strongly urge the FSB to undertake a careful analysis of the differences in the type of cover offered by mortgage credit insurers across different jurisdictions. In this respect, not all mortgage insurance products are identical and they do not all necessarily facilitate credit creation. Regulated insurance firms provide mortgage insurance which provides insurance for the mortgage holder as opposed to the issuer of the mortgage.

Insurance Europe will comment on sections 2.4 (facilitation of credit creation) and 2.5 (securitisation and funding of financial entities).

2.4 – Mortgage Insurance

It is important for the FSB to acknowledge that mortgage guarantee insurance products offered by insurers can differ significantly between countries. It is therefore not easy to arrive at a consistent understanding of what constitutes a mortgage guarantee product and how the exercise of the product is linked to the economic cycle. In this regard, we would suggest that mortgage insurance products that are not correlated to the economic cycle (e.g those related to disability, mortality or sickness of the mortgage holder) and that are provided by insurers subject to prudential regulation be excluded from the scope of the FSB framework.

2.5 – Securitisation

As previously mentioned, insurance Europe strongly supports the statement made in the FSB consultation that "when applying policy tools to securitisation entities, regulators should firstly acknowledge the difference between traditional bank-based securitisation structures and those put in place by other both financial and non-financial entities".

With regard to insurance-linked securities (ILS), we consider it vital that both the FSB and regulators implementing the policy framework keep in mind that:

- There are significant structural differences between bank-based securitisation and that undertaken by insurers. In particular, ILS vehicles do not perform maturity transformation. As a result the potential for a maturity mismatch between securities issued and the underlying pool of assets is limited.

- Existing levels of disclosure by issuers of ILS are sufficient with regard to investors and supervisors. In addition we would consider existing levels of disclosure by ILS vehicles to largely fulfil the reporting requirements set out by the proposed FSB policy toolkit.

- A recent IAIS report, "Re-insurance and financial stability", noted that the outstanding volume of ILS was significantly less than the total volume of outstanding asset-backed securities[1] and concluded that "it is difficult to see how the marginal ILS market could give rise to systemic (risk) concerns".

[1] "Reinsurance and financial stability" International association of Insurance supervisors, 19 July 2012

Comments on FSB consultation: "A policy framework for addressing shadow banking risks in securities lending and repos" (Work Stream 5)

Insurance Europe welcomes the opportunity to respond to the FSB consultative document on policy recommendations to address shadow banking risks in securities lending and repos markets.

Insurance Europe considers it important that the process of strengthening securities lending/repo market frameworks strikes a balance between the need to strengthen the stability of the financial system and the potential cost to firms of implementing the proposed measures, which could ultimately affect the liquidity of the securities lending market. Both securities lending and repo transactions are undertaken by insurers for the benefit of policyholders (eg the generated income helps to lower the level of insurance premiums). Increasing the cost of conducting such activities could result in increased cost for insurance policyholders.

Insurance Europe would urge the FSB to undertake an appropriate cost benefit analysis prior to the implementation of the proposed measures to ensure that the cost of implementation is considered against the potential for the measure to reduce systemic risk. In certain cases the FSB recommendations could generate significant additional charges for insurers without necessarily reducing the potential for systemic risk. This is particularly true in the case of the proposed implementation of minimum requirements for collateral valuation frameworks which could result in a shallower collateral pool being available to investors. Every effort should be made to ensure that the costs of implementation do not outweigh the potential financial stability gains which could result.

In addition we would encourage the FSB to limit the cost of additional reporting requirements wherever possible by building upon pre-existing financial reporting structures at both the international level (through IFRS) and the sectoral level (relevant sectoral supervisory reporting). Every effort should be made to ensure that duplicative reporting requirements are avoided.

Insurance Europe considers that extensive international supervisory cooperation is vital to ensure that the potential for regulatory arbitrage is limited. Arriving at an internationally agreed definition of what constitutes a securities lending and/or repo transaction is essential.

Please find our responses to the consultation questions below.

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 that the FSB should have addressed? If so, please identify any such risks, as well as any potential recommendation(s) for the FSB's considerations.

Insurance Europe considers the consultation document to adequately identify the financial stability risks in the securities lending and repo markets, however the potential new risks that could be introduced by some of the proposed tools are relatively unexplored and we believe that this is a serious shortcoming.

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?

Insurance Europe considers it appropriate that the risk of maturity and liquidity transformation resulting from cash collateral reinvestment (1.1 ii) is addressed at the level the cash collateral is reinvested.

Financial stability risks arising from unlimited re-hypothecation of client assets (1.2 iii) can best be addressed through increased transparency rules so that market participants know to what extent intermediaries have used client assets for the purpose of re-hypothecation or through application of a specific capital charge for these transactions. Full transparency of collateral re-hypothecation would act to dis-incentivise and ultimately limit the extent to which clients' assets are re-hypothecated.

In specific cases not allowing for re-hypothecation generates an important liquidity problem. Insurance Europe believes that an appropriate measure to overcome potential liquidity shortfalls, while limiting the potential for systemic risk via re-hypothecation, would be to limit the re-hypothecation of collateral. Re-hypothecation would be permitted within pre-defined limits and the limits would be applied to all contracts.

The policy goal of improving collateral valuation standards (1.2. v) should be to increase the accuracy and the reliability of collateral pricing. Nonetheless, the proposed continuous marking-to-market of collateral for the purpose of avoiding inadequate collateral valuation can have a pro-cyclical impact during periods of market disruption, when a reliable valuation of collateral may be unobtainable. In this situation, it may be appropriate to determine the intrinsic value of collateral on the basis of reasonable assumptions. Collateral valuation standards should therefore acknowledge that depending on the circumstances, alternative methodologies to continuous marking-to-market valuation should be permissible.

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.
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)?

Insurance Europe considers that an extended period for phasing in any new measures would be required. Establishing the proposed infrastructure and reporting schemas, as outlined by the consultation document, will take time. In this respect a period of between 18 – 24 months could be considered an appropriate timeframe.

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.

Insurance Europe would strongly urge the FSB to consider the cost to firms of implementing reporting requirements that are both significant and specific. In this respect, Insurance Europe would like to highlight the fact that the benefits generated by securities lending and repo transactions are, directly or indirectly, passed to policyholders. Therefore, every effort should be made to ensure that the cost of engaging in both securities lending and repo transactions does not become prohibitively high and eventually harm policyholders. In addition suitable legal assurances would be required in cases where firm-level data was transmitted.

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?
Insurance Europe considers trade repositories (TRs) to be the most effective way to aggregate repo and securities market data. It is therefore important that a globally applicable definition of what constitutes a

securities lending, and a repo transaction, is agreed upon. From a geographic perspective TRs should be established at a 'continental' (North America, Europe, Asia) market level.

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?

Every effort should be made by authorities to ensure that additional costs are kept at a minimum. The guiding principle should be to ensure that the costs of establishing TRs not outweigh the potential benefits to both firms and the wider financial system.

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.

We believe that the enhanced disclosure items would be useful for market participants. However, it is important to recognise the significant difficulties that firms face in deriving a number of the suggested items.

Percentage of collateral pool reused, broken down by client vs. own activity. Most financial entities, regardless of their business model would, in practice, be unable to provide such specific information about client activity. In particular, insurers generally undertake financial market activities such as securities lending and repo for the benefit of policyholders (eg so as to reduce the level of premiums). Given the uncertainty regarding future insurance claims, it would be impossible to provide a workable breakdown of collateral pools based on a client's own activity.

Credit risk exposure broken down by securities lent, securities borrowed, repo and reverse repo: Implementing a precise method of valuation with a specific standard chosen from a regulatory perspective would take time to incorporate into firm specific internal models. In this respect time will be needed to allow firms to achieve consistency between existing and proposed regulatory standards and valuations based on internal models.

The reporting requirements as mentioned in both recommendations 2 and 3 should in all cases take account of the reporting requirements proposed by other regulations, such as the EMIR regulation in the EU and the Dodd-Frank act in the US. Efforts should be made to ensure the highest possible level of convergence between the different reporting requirements, in order to minimise implementation costs.

Moreover, the proposed increase of disclosures in corporate documents should be aligned to existing reporting rules under national GAAP's, IFRS and in the case of insurance, the expected Solvency II reporting schema. Every effort should be made to ensure that duplicative reporting requirements are avoided.

In addition, the level of granularity required for supervisory purposes may not be appropriate or achievable outside of standard financial disclosure cycles.

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.

We do not believe that improved fund manager reporting would be useful for investors. Investors generally have *ex-ante* knowledge, through the investment mandate and term sheet, of the extent and type of repo or securities lending transactions that can be conducted by fund managers. In addition investors will receive further information *ex-post* through regular fund reporting. It should be borne in mind that costs incurred by fund managers with respect to additional reporting requirements will ultimately be borne by investors through reduced net fund performance. Therefore, any recommendation in this respect should be made following a cost benefit analysis which shows that the benefit of having new disclosure requirements outweighs the reduction in investment performance.

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 factors described by the consultation could be considered a complete and exhaustive list of the elements required to establish risk-based haircuts. However, in practice the application of the proposed factors in setting risk-based haircuts could be difficult and costly for firms to implement. Generally speaking, the incorporation of the correlation between collateral asset and counterparty default into haircut valuation methodologies could result in a significant decrease in the volume of suitable collateral available.

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 pro-cyclicality risk? Do the types of securities identified in Options 1 and 2 present a material pro-cyclical risk?

The potential benefits and unintended consequences are dependent on the option applied. However it is important to also consider the potential impact of imposing a high numerical floor on haircuts on the availability of sufficient eligible collateral. The absence of sufficient and eligible collateral could result in financial markets becoming increasingly vulnerable to liquidity shocks as a result of a dependency on a smaller pool of eligible securities. This could in turn have negative implications for the stability of the financial system.

Conversely, if haircut floors are set too low then there is a potential moral hazard risk that participants may abdicate their responsibility to conduct their own risk analysis and simply gravitate to the regulatory minimum haircut as a market standard. There is also a danger that where 'haircuts' are not calibrated to firm's individual risk appetites, this could lead to pro-cyclical effects.

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 pro-cyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets?

Insurance Europe notes that both options for implementing numerical haircut floors for valuing collateral in securities lending transactions are based on the Basel III framework. We do not consider the application of standards designed for banks to be necessarily suitable or applicable to insurers.

With respect to well-functioning and liquid markets, Insurance Europe would advocate the use of option 2 as a basis for implementing numerical floors for securities lending for cash collateral. In this respect, the potential costs of implementing the proposed option 1 are significantly greater than the potential financial stability gains which could result from its implementation. Higher margin requirements could have a significantly negative impact on the volumes of business undertaken in securities lending markets. Lower volumes of business could in turn have a negative impact on market liquidity.

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

Exchange rate risk should also be incorporated when setting a numerical haircut floor.

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?

The proposed numerical haircut framework would impose additional constraints on existing model based haircut methodologies. An extended phase in period should be defined in order to allow firms to adapt to the changes.

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 pro-cyclicality risk associated with securities financing transactions, while preserving liquid and well-functioning markets?

The appropriate scope of application of a framework of numerical haircut floors is complicated by the need to categorise transactions by type as the motive for engaging in a transaction is not always easily identifiable. We would suggest that the framework be applied to all market participants (option ii). Such an approach would reduce the possibility for regulatory arbitrage between both markets and entities and would ensure that potential market fragmentation is limited. The numerical haircut floors should follow existing and proposed regulation with regard to the application of numerical floors to sovereign bonds used as collateral.

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.

An example in this case would be the interpretation of investment classifications undertaken by specific fund structures. The subjectivity of the proposed look-through approach to be applied to UCITS, in particular under 'other' investments, could pose significant difficulties in the application of haircut methodologies[2]. In all cases the potential for subjective interpretation of guidelines in the application of minimum haircut floors should be as limited as possible, in order to minimise the risk of discrepancies between different internal models and approaches among market participants.

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?

The framework should allow for a portfolio perspective and implicitly apply to transactions for which margins are set at the portfolio basis. In practice most market participants use baskets of (more or less) equal collateral, from which the counterparty can choose. Every effort should be made to maintain floors for assets which allow for the realisation of accounting and diversification benefits at the portfolio level.

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?

The proposed minimum standards for the reinvestment of cash collateral should in all cases seek to limit the potential to negatively impact the positive benefits of securities lending and repo transactions for both firms and consumers of financial products. In this respect any potential financial stability benefits of implementing minimum standards should be carefully considered against their impact on the ability of securities lenders to effectively reinvest cash collateral.

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[2] For example, UCITS are permitted to invest up to 100% of net assets in other collective investment schemes (CIS), provided no more than 20% is invested in any one CIS, with an aggregate restriction of 30% of net assets applying to investment in non-UCITS CIS as well as strict rules applying to the nature of CIS in which a UCITS can invest, as well as limiting investment to a maximum of 25% of the units of the underlying CIS. This would make the look-through approach very difficult to apply in practice.

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

Insurance Europe can welcome the principles set out in recommendation 9. However, it must be noted that the situation is complicated by the lack of harmonisation as regards material law when securities are held by an intermediary.

Furthermore, it is important to differentiate between corporate law and securities law in accordance with respective national legal systems. Corporate law deals with the relationship between the issuer of the security and the end investor (who invests in the security on his own account and who bears the risk of the investment). Corporate law therefore covers the rights and obligations involved in the beneficial ownership of securities. In contrast, securities law exclusively covers the relationship between the account holder and the account provider. The legal position established by corporate law should not be adversely affected by the immobilisation of securities to the detriment of the end investor. It is important to ensure that national corporate law takes precedence over that which is established through securities law.

A greater transparency of ownership and account structures can assist in reducing the information problem regarding ownership of securities. However transparency is in any case not enough; the most important thing is that the account provider follows the rules and that the account holder has a right of separation regarding the securities in the account.

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?

Insurance Europe is somewhat concerned by the ambiguity of point 3. In particular it should be clearly established who sets the “minimum acceptable threshold”. The variation margin is an essential tool in effective collateral management. If an international standard is to be established, it is essential that the potential for ambiguous interpretation is in all cases avoided.

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?

Insurance Europe has significant reservations regarding policy recommendations which in our view are based on studies with a significant emphasis on US bankruptcy law. Given the bankruptcy context of the recommendations, a more in-depth analysis of the differences and similarities in global bankruptcy law is required for the recommendations to be appropriate and applicable at the global level. In addition we note that neither the studies mentioned, nor the consultation document itself, provide a clear and workable definition of what constitutes illiquid and risky collateral. Further study is required to arrive at a working definition of what could be considered “risky and illiquid” collateral in the context of the three proposals on the privileged status of repo transactions in the event of bankruptcy.

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