Amundi
ASSET MANAGEMENT

Comment on F S B's Consultative Document Strengthening Oversight and Regulation of Shadow Banking

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

(January 2013)

Amundi is a **leading asset manager**, ranking second in Europe and among the top ten in the world with assets under management above 700 billions euros. It is active in many different countries and serves a diversified clientele of retail, corporate and institutional investors through a large range of products and investment solutions.
If it uses Repos and securities lending it is most often as an investor who wants either to secure large cash holdings (through a reverse Repo) or in order to get an extra income for the benefit of investment schemes holders through securities lending. These EPM (Efficient portfolio management) techniques are not used to get extra leverage. Securities borrowing might become more common as a way to gain eligible collateral in the near future. Furthermore structured funds may also use EPM techniques as a way to reduce counterparty risk. **These techniques do not lead to systemic risk on the part of funds that are strongly regulated and closely supervised.**
Thus, Amundi is very happy to send its comment on Repos and securities lending to FSB and to participate to the discussion on a topic where it can present the views of an asset manager. Amundi brings an answer to questions where it feels that its experience has some relevance and may contribute to a better understanding of these activities.

General questions (Please provide any evidence supportive of your response, including studies or other documentation as necessary)
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.
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?

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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)?

As a general comment and in order to answer the first introductory questions of the consultation paper, Amundi would like to underline the following points:

- as properly mentioned, shadow banking is not *per se* to be considered as delinquent and/or dangerous: it brings real contribution to finance the economy, and **it is more the excess of repo and securities lending (R and SL) that can prove dangerous than its essence**;
- asset management should be considered with specific care, as it is a highly regulated activity and closely supervised by specialized local regulators; **in particular UCITS developed under the European legislation present all qualities to be considered as free of any systemic risk**;
- many questions relating to dangers created by re-use and re-hypothecation should be addressed keeping in mind the legal framework of securities law: in continental Europe, there cannot be any creation of stocks or bonds through re-hypothecation or re-use as, contrary to English or American legislation, **securities law demands a permanent equivalence between the number of shares issued and that kept in custody** for the account of all holders by all custodians;
- recommendations on R and SL should anticipate the coming **impact of new regulations, namely Dodd Frank Act in the US or EMIR in Europe,** on derivatives that will impose an extended use of collateral; in order to get eligible collateral some investors may for example, when they do not hold such eligible assets, enter in collateral swaps or securities borrowings that will themselves be submitted to collateralisation with (unavailable by hypothesis) eligible assets: thus re-use may simply be a necessity;
- key principles (expressed page ii of the Preface) to **proportionate the burden of regulation to the level of risk and to introduce a threshold of materiality** are essential to develop appropriate regulation.

<u>Recommendation 1</u>: Authorities should collect more granular data on securities lending and repo exposures amongst large international financial institutions with high urgency. Such efforts should to the maximum possible extent leverage existing international initiatives such as the FSB Data Gaps Group, taking into account the enhancements suggested by the Workstream.

<u>Recommendation 2</u>: **Trade repositories (TRs) are likely to be the most effective way to collect comprehensive repo and securities lending market data. The FSB should consult on the appropriate geographical and product scope of such TRs. The FSB should encourage national/regional authorities to undertake feasibility studies for the establishment of TRs for individual repo and securities lending markets, as well as**

coordinate and facilitate those efforts. Depending on the consultation findings on the appropriate geographical and product scope of TRs, the FSB should also establish a working group to identify the appropriate scope and undertake a feasibility study for one or more TRs at a global level. Such feasibility studies should involve market participants.

Recommendation 3: As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such market-wide surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.

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.

Generally, it is advisable to refer to reporting that is about to be introduced in local regulations as EMIR in Europe before deciding the relevant items: it **should be coordinated** and avoid differences. Three specific comments on items listed in box 1:

- securities available for lending is not a relevant concept as it is not defined and potentially all securities are available for lending
- ultimate counterparty should not be disclosed as it would break the confidentiality duty of the intermediary towards its client
- repo rate is by nature a confidential piece of information and should not be disclosed publicly.

The level of granularity to be achieved at firm level and on aggregate data has to be determined more precisely. It sounds very, far too much indeed, detailed in order to make the indication of repo or lending rates significant or to specify the rules for re-hypothecation.

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?

Compared to official surveys and regulatory reports, TRs represent an effective way to collect data. However, regulators should be concerned not to impose heavy costs on market participants and before concluding that it is the most convenient avenue, its real cost should be assessed.
Geographically, it sounds useful to reduce fragmentation: one (and not several) TR for one currency zone.

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?

In that study it is most relevant to decide **who will be responsible for reporting**. Amundi suggests that in the case of funds it be the depositary holding the accounts of the fund in case of bilateral transactions or the third party in case of a three party contract.
Cost and delays for implementation are significant as for any reporting on large quantities of data with many different counterparties: IT developments will be required of a minimum of 2 years after final regulation has been published. A phasing parallel to EMIR implementation delays is a good option, especially if contents can be unified.

Recommendation 4: The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities as needed, taking into consideration the items noted above.

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.

The listed items in 2.3 relate to corporate disclosure and are absolutely not designed to funds and investment schemes. These entities should only apply the requirements of recommendation 5 to both holders of the funds and regulators.
Asset management is directly concerned by recommendation 5, see below.

Recommendation 5: Authorities should review reporting requirements for fund managers to end-investors in line with the proposal by the Workstream.

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.

The list of items listed under §2.4 is not relevant to funds in general. A line should be drawn between **hedge funds** and retail products with a leverage lower than 1:3, such as UCITS in Europe. Disclosure should be much more detailed for hedge funds that use R and SL as a technique to arbitrage markets and to refinance. Disclosure similar to the suggested items might be appropriate for them.
On the contrary, **UCITS** that cannot hold an exposure to markets higher than 2 for 1 should be exempted from the projected report. For UCITS, **ESMA published guidelines** in December 2012 that require information to be disclosed in official documentation and regular reports. It is very demanding for the industry and relevant to the investor. Amundi strongly recommends referring exclusively to that regulation for UCITS. When a degree of leverage in excess of 3:1 is observed listed items might be relevant for investor's information.

Recommendation 6: Regulatory authorities should introduce minimum standards for the

methodologies that firms use to calculate collateral haircuts. Those guidelines should seek to minimise the extent to which these methodologies are pro-cyclical. Standard setters (e.g. BCBS) should review existing regulatory requirements for the calculation of collateral haircuts in line with this recommendation.

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?

In order to avoid procyclicality, haircuts should not be subject to reassessment and should remain stable. It should not be overlooked that when regulating haircuts, we refer to risk of the third level: initial risk lies with the counterparty of the reverse repo, second level risk is in the quality of the securities received and third level relates to the haircut. In the case of structured funds with a guarantee there is even one more level: the credit risk of the guarantor, which makes the haircut totally marginal in terms of risk management and almost irrelevant.
This remark prompts to a stable prudent and standardized approach to haircuts. Focus should be directed on the proper and regular valuation of securities received and their immediate legal availability in case of need.

Recommendation 7**: In principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets. The FSB should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives. This would include consultation on the levels and the scope of application of such framework by counterparty, collateral, and transaction type (see sections 3.1.4 - 3.1.5).**

12. 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?

In general, **Amundi does not favour the introduction of a framework of numerical haircut floors**. As mentioned a minimum might become, under commercial pressure, a reference for all participants and thence either increase the global risk (if too low) or reduce the number of transactions and the liquidity of the markets (if to high). Market participants should be able to keep a differentiated approach based on many non algorithmic factors including the type of transaction, the presence of a third agent or not, the quality of the depositary, the type of contract, the portfolio concerned, the former experience with the same counterparty…

The fact that the proposed schedule does not refer to any rating is positive to fight over-reliance on rating agencies. On the other hand, it reduces the possibilities to develop a better granularity and accept lower haircuts on better assets.
Worth noticing also the look-through approach for funds, which will only be workable on the basis of a monthly reporting and with some delay. The alternative to refer to the worst possible case is too stringent and should allow for neutrality on assets that cannot exceed 10% of the Net Asset Value.

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?

Putting aside the negative view on numerical floors on haircuts, it is impossible to express a view without taking into account the scope of the numerical haircut framework: for some entities or activities one or the other of the two options or a full exemption (see footnote 13 on page 16 concerning securities lending and cash collateral) might be better adapted.

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?

The reference (page 14) to the schedule proposed by the WGMR for non-centrally cleared derivatives and to Basel 3 requirements is important as consistency throughout different regulations is essential for market participants.
Amundi suggests that, if, contrary to its suggestion, the idea of a numerical floor on haircuts is introduced, a two level approach be considered. On one hand, the proposed schedule would then be considered as a standard approach conceived as prudent and on the other hand it would be possible to overrule it by reference to a model approach based on models approved by the concerned regulator. This two way approach would offer both strict minimum rules and flexibility (subject to approval). Note that when a model has been agreed upon by one regulator it should be eligible for its counterparties, even if they are regulated by another authority. But Amundi prefers to rely on market practices and self regulation in matter of haircuts.

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?

Amundi supports WS5 analysis that only transactions aiming at refinancing and developing high leverage should be subject to haircuts numerical floors and that cash collateralised

securities lending should be left out of scope. As soon as they participate to a refinancing transaction that will bring high leverage, collateral swaps should also be subject to floors.
On the contrary, Amundi does not share the analysis conducted on the counterparties as it only divides the world in two sides: prudentially regulated financial entities and other entities. That last part cannot be considered globally without taking into consideration the level of risk they may generate. More specifically **funds with low leverage (less that 3:1) are not prudentially regulated entities, but are strictly regulated and closely supervised entities that bring no significant risk** as their capital cannot be exposed more than 3 times to market variations, what arguably represents a minimum capital requirement of 33% far higher than anything applying to banks and prudentially regulated entities! It is of prime importance that counterparties are analysed according to both the degree of regulation and supervision they are subject to and the level of leverage they are allowed to reach. Transactions with non regulated or quasi-non regulated entities should be the priority for the application of numerical floors. Transactions between banks should be submitted to haircuts according to either their internal models or the standard minimum approach, depending on their degree of sophistication. Transactions between banks and non banks should be subject to haircuts according to banks policies (indirect regulation) and take into consideration the specific case of counterparties not regulated at all.
The discussion about the opportunity to introduce minimal regulatory haircut on sovereign bonds is effectively relevant as it refers to State Sovereignty, a key political issue, and to currency supervision, another key political issue, especially in the framework of a currency union with a single central bank as the Eurozone. The notion of risk free interest rate applies to the best (one or a small number of homogenous countries) of all countries constituting the zone; all other sovereign bonds present a spread**.** Sovereign bonds should not be included in the scope of standard regulatory haircuts but should be accepted with the same rules as applied by the central bank which accepts them for refinancing. Procyclicality would hence be in the hands of the central bank and there would not be room for regulatory arbitrage.

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.

The only way to deal with difficulties in the application of numerical haircut floors is to introduce carve-out provisions for these transactions. **The case of cash collateral of securities lending** has been outlined as an example where the transactions is led by the securities borrower who does not want to leverage and is ready to post high cash collateral.
Reverse Repo transactions should also be exempted from minimal haircut requirement. They are used as a secured way to use excess cash on a day to day basis. They are only conceived, from the viewpoint of a Money market fund for example, as a safer alternative to bank deposit as they reduce the counterparty risk thanks to securities transfer. Subject to a call on demand cash may be returned as soon as the fund manager requires it. Minimal haircut requirement seems inadequate in these transactions.
More generally it is of prime importance that entities such as low leverage highly regulated funds be outside the scope of the regulation on numerical floors on haircut.

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?

Most often margins are set at **the portfolio level** and it is not possible to ask for any other approach, as the risk should be appreciated at the client's level and not on the basis of one transaction isolated from the context. In that respect the use of models is common practice and should be encouraged.
Calculations of haircuts being based on collateral posted, it is not a difficulty to first compute the level of collateral needed, including correlations and write offs, and then turn to the haircuts.

Recommendation 8: Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.

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?

Asset managers are directly concerned by this recommendation as they may manage portfolios for the three categories mentioned page 19: pension funds, mutual funds and insurance companies. Amundi broadly agrees with the idea of expressing a policy of reinvestment of cash collateral. However, Amundi submits some specific comments:

- Money Market funds should be expressly mentioned as highly liquid short term assets page 21;
- WAM and WAL definitions should, in Europe, be consistent with CESR's regulation of Money market funds in May 2010;
- ESMA issued guidelines on collateral which are properly aimed at funds; they include a maximum concentration ratio of 20% and a stress test in case of collateral amounting to more that 30% of the NAV of a fund; that type of decision should be considered as fulfilling FSB suggestions and taking into account the materiality issue;
- Disclosure requirements as proposed are not adjusted to the reality of funds which have constraints of timely disclosure to holders and confidentiality; furthermore, illiquid assets are not eligible to most funds.

Recommendation 9: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:
• Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;

• In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and

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• Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

<u>Recommendation 10</u>: An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation.

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

According to the proposed definitions (p22), asset managers are not in a position to re-hypothecate and are only concerned with re-use of securities. Effectively, they do not hold assets of their clients but manage portfolios in the best interest of the holders of the funds. Nevertheless, portfolio managers want to be able to authorise counterparties to re-hypotecate their assets in some well defined circumstances, as it may reduce the cost of some transactions and be in the best interest of holders. **"No re-hypothecation without our prior consent!" should be the rule.**
For re-use, **Amundi shares the view that it should be authorised as long as it does not lead to excessive leverage**. Funds are closely risk controlled and the leverage is one significant ratio that is constantly monitored by dedicated teams within the asset management firm. Thus, there is no difficulty in assessing at first sight the level of authorised and realised leverage of a fund.

<u>Recommendation 11</u>: Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.

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?

Access to securities received as collateral very much depends on applicable security and bankruptcy laws. A specific effort to **improve securities law,** in order to make it impossible to have more certificates in circulation than shares issued, should be on the agenda of FSB. Counterparties should be authorised to value collateral and exchange margin calls less frequently than daily if they agree for higher margins and/or haircuts.

<u>Recommendation 12</u>: Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.

<u>Recommendation 13</u>: Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.

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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?

CCPs are supposed to clear deals sufficiently standardized and liquid. That principle applies to derivative instruments and should apply to R and SL transactions. The provisions of EMIR for mandatory central clearing include an assessment of these two criteria by ESMA, on top of the examination conducted in the process of authorisation given by the local regulator to clear a new contract. This regulatory framework seems appropriate. However, specific attention should be dedicated to the expected duration of a transaction and the cost involved: **proportionate regulation should lead to exemptions for short term operations.**
Safety of R and SL is of prime importance and any envisaged modification to existing rules should be subject to extended consultation and worldwide impact assessment. There is no need to rush into changing bankruptcy laws. However, FSB and WS5 should prioritise the revision of securities law in order to make it impossible to have more certificates running than the number of shares issued. It proved to bring real confusion at the time of Lehman's failure and would be of great help in order to increase safety of financial markets at large and R and SL transactions more specifically.

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