association of the luxembourg fund industry

ALFI comments

on

Financial Stability Board ("FSB")

Consultative Document

Strengthening Oversight and Regulation of Shadow Banking

- **An Integrated Overview of Policy Recommendations**
- **A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities**
- **A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos**

18 November 2012

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership asset management groups from various horizons and a large variety of service providers. According to the latest CSSF (Commission de Surveillance du Secteur Financier) figures, on November 30, 2012, there are 3 863 undertakings for collective investment in Luxembourg (UCITS and non-UCITS), representing 13 481 active compartments representing a total, in terms of net asset value EUR 2 359.722 billion.

ALFI welcomes the Financial Stability Board Consultative Document on Shadow Banking (hereafter, the "Consultative Document") and welcomes the opportunity to provide its comments and expertise to the FSB work stream on this issue.

To provide context to our response thereon, we would like to stress the following points.

- ALFI agrees with the need to ensure all aspects of the financial system are properly regulated.
- ALFI fully supports a level playing field of appropriate regulation covering such activities.
- ALFI believes that it is important to ensure any such regulation is proportionate to the risks being addressed.

Regarding the questions raised in the document "A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities":

Questions (Please provide any evidence supportive of your response, including studies or other documentation as necessary)

General

ALFI welcomes the concept of proportionality and of keeping the principles flexible, but would like to stress the following overarching principles:

1. Proportionality of regulation is important and to this end, care should be taken to ensure systemic risks are understood and proven and that the risk measures introduced remain focused on such systemic risks – for example, we would question whether any systemic risk exists for much of the mutual fund world and thus whether there is any proven value for systemic risk regulation.
2. Consistency of approach and reporting requirements becomes increasingly critical as the industry struggles to cope with an ever increasing patchwork of overlapping regulation – as such, we have concerns as to the tool-kit approach if this were to lead to an increasingly disconnected regulatory landscape globally.
3. AFLI fully endorses the position on Money Market Funds, EFAMA developed in the context of this Consultative Document.

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

We agree generally with the high level policy framework. However, we would like to stress the importance of the application of proportionality when determining and applying the policy toolkits "that authorities should apply for all economic functions" to mitigate the **systemic** risks associated with these functions. In addition, we have the following comments/observations:

1. It is stated that the scope of the consultation is limited to credit intermediation whereas this document refers to situations which seem to go beyond – such as the risk of runs on investment funds. We think it is important to be clear on the scope of the consultation and the nature of the risks seeking to be covered to avoid unnecessary regulation. In addition, the policy is then to narrow the focus to a sub-set of activities where there is an increase in systemic risk and/or indications of regulatory arbitrage. We would suggest that the policy approach should seek to address arbitrage only when there is a risk of increased systemic risk. In addition, it should be noted that the risk of runs is a risk inherent to investments in the financial markets in general when investors seek to de-risk together and is not limited to money market funds.

2. We are similarly concerned that in the current economic environment, any policy which would serve to restrict appropriate access to credit for various economic actors should be strongly avoided – as such, overt regulation on funds over and above that provided by the respective fund regimes providing debt financing should only be considered where systemic risk is demonstrable.

3. Capturing activities by economic function is intellectually compelling as any framework should help in reducing the risk of regulatory arbitrage. However, this reduction of regulatory arbitrage should also be ensured by clear definitions of the relevant functions and concepts and care should similarly be taken to avoid unintended consequences.

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

We do not see any additional non bank financial activities which could be covered.

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

We generally agree that information is an important element to enable supervisory authorities to monitor adequately systemic risk. However, it is also crucial to avoid duplication/overlap with existing reporting requirements - reporting burdens are becoming extremely onerous and care should be taken to match new requests with existing requirements (such as AIFM/UCITS in Europe) to minimize the need to re-analyze data in slightly different ways and to take advantage of what already exists.

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

The idea of identifying policy toolkits is generally welcomed subject to our concern over the potential for patchwork regulation and regulatory arbitrage. Specifically for (all) funds, we would like to reiterate the following key points:

1. Risks linked to so-called “runs on funds” are purely a function of the liquidity and quality of the underlying portfolio together with the commensurate requirements of the fund (closed ended, open-ended with daily, weekly, monthly or other) to provide for redemptions and other tools which may exist (gates, swing pricing etc) to mitigate redemption flows. If the liquidity needs are properly managed at fund level, there is no need to limit investments in illiquid assets or to provide for a liquidity buffer, except in exceptional market conditions.

2. Existing regulations (UCITS /AIFMD) already impose duties for investment funds to put in place risk management processes and in particular liquidity risk management which also mitigates the risks. Liquidity is variable and depends on various contextual factors that might affect it such as the nature and concentration of the investor and the underlying assets base deemed to be liquid today might not be liquid tomorrow (or vice versa) depending upon market conditions hence any solution needs to be dynamic – we refer you to Appendix 1 of this document which maps systemic risk considerations to the existing rules of UCITS and the AIFMD. (Table of risks covered by measures implemented by UCITS & European Money Market Funds and by AIFMD, enclosed herewith)

3. Regarding the "securitization and funding of financial entities", we understand the importance of regulating the type of collateral in order to avoid illiquid assets; otherwise for UCITS ETFs - synthetic and physical - the recent ESMA guidelines 2012/832 have recently reinforced the current stringent rules for UCITS using collateral.

With the arguable exception of money market funds, we see no requirement to support further action to be taken at a global, systemic level on funds. Even for money market funds, we believe the primary focus should be on ensuring proper risk management and planning across all key risk dimensions – in this case specifically liquidity risk. Developing further liquidity rules runs the risk of restraining possible investments for regulated funds which would impact both the availability of capital (in debt or equity form) for the underlying issuers and the attractiveness of regulated investment funds which could then shift certain investors into less regulated products.

Specific comments on the tool-kit are summarised as follows:

Limits on Leverage:

Limits on leverage should be seen as an extreme measure only – i.e. for those entities deemed systemically important. The monitoring of leverage as is already provided for in Europe either in the UCITS or AIFMD regime through risk management process and reporting should be privileged or there is a risk that some type of investment strategies will not be manageable anymore. Should a limitation on leverage be imposed despite our position above, the definition of the concept and the calculation methodology should also be defined to avoid regulatory arbitrage between jurisdictions.

Side pockets:

Side-pockets are again an extreme measure – essentially introducing a separate pool of assets within the fund which are not subject to the fund's standard redemption requirements. These are rare and generally seen more in the alternative funds world during extreme circumstances and we would concur that they are valuable policy tools but only in extremis and care should be taken to avoid abuse.

Redemption fees and other tools:

Under a number of fund regimes in the EU, swing pricing or dilution levies already exist. We believe providing such flexibility across member states for all types of funds should be considered. We understand that the proposal of tool 4 d) is a mere penalty to limit redemptions in certain market conditions and would not be applied to protect current shareholders remaining in the investment funds against net subscriptions and redemptions as is the case for swing pricing or dilution levy. As such, we would recommend that consideration is given to the range of tools which currently exist in various jurisdictions allowing funds to manage liquidity risk in times of stress.

Redemption Restrictions:

Imposing regulatory restrictions on redemptions would in our view serve to change the nature of certain investment funds and especially money market funds and introduce an uncertainty of a "race to beat the limit" which would only serve to exacerbate the challenge of managing liquidity. Imposition of such restrictions would in our view severely limit the attractiveness of such vehicles. In addition, flexibility already exists at the level of many funds – allowing funds the flexibility whilst avoiding requirements to act would be beneficial and as such prescriptive requirements in this area should not be introduced.

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

Again we welcome proportionality implying that actions taken are proportionate to the actual systemic risk which has been identified and also recognizing that the catch-all approach by function is intellectually compelling but needs to be very clear on objective and scope to avoid unintended consequences and legal uncertainty.

Regarding the questions raised in the document "A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos":

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.

ALFI has no special view on this.

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?

ALFI has no special view on this.

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?

ALFI has no special view on this.

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.

ALFI has no special view on this.

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 risk?

In order to align these recommendations with the ESMA guidelines on UCITS and the AIFMD implementation timeline, we recommend to apply these new rules by end of 2013 with a grandfathering clause until July 2014.

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

We are fully supportive of enhancing transparency in securities lending and repo markets with information as stated in Box 1. Nevertheless it should be borne in mind that items listed in Box 1 are already available at the transaction level through existing Central Banks' reporting.

Securities and lending transactions could be structured in two ways: either via a regulated repo transaction or via a synthetic trade by using a derivative instrument. We would like to point out the importance of including synthetic "repo like" transactions (for example sell and buy back using a total return swap) in order to have a level playing field in the market. In our following answers, we will refer to such transactions as "Synthetic Repo like transactions".

In order to avoid confusion in the data collection process and introduce the proportionality rules, we suggest restricting the reporting at the transaction level only via the trade repository, and leave it up to the regulators to aggregate the data on a regular basis as needed.

As a practical point we suggest including the disclosure requirements dedicated to the cash collateral reinvestment within the already existing official communications of the entity concerned (i.e. quarterly, semi-annual and annual report) rather than proposing an additional reporting framework.

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?

As stated above (cf. Q6 answer) we agree the most effective way to collect comprehensive market data for securities lending and/or repos would be the collection of data at the trade repository level.

However to ensure a level playing field these trade repositories should also cover synthetic repo like transactions. Post-trade clearing and settlement engines should be used as collection mechanism for all transactions (i.e. including synthetic deals).

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?

No more additional topics than those previously exposed.

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 confirm the enhanced disclosure items listed above would be useful for market participants and authorities. So we propose to include them within the annual report, as e.g. required by the ESMA guidelines (ESMA/2012/832 of 18th December 2012) for UCITS.

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.

As already confirmed we are in favor of enhancing disclosure to investors. Nevertheless fund managers should not be subject to more intensive or detailed disclosure requirements than other institutions active in the securities lending and repo markets.

In addition, for certain strategies, we have practical issues to provide relevant information for some items - for example for "the re-use and re-hypothecation data" *within a market neutral strategy the borrowed stocks are simply used to settle the short sales and therefore are not an optional mechanism to enhance the performance. For the same reasons we foresee similar difficulties in the reporting of the split between the return from repos / securities lending and the return from cash collateral reinvestment.*

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 in section 3.1.2 may be appropriate to capture important considerations that should be taken into account in setting risk-based haircuts. However by reference to the heterogeneous levels of frequency between institutions in trading repos or stock lending transactions, a flat rate calculation method (like below "High level" or "Back Stop" proposals) should be adequate to be sustained as a standard default rule. Proprietary models, using such factors described in section 3.1.2 with in-house estimation at the firm level could be retained as alternative methodologies subject to an independent validation by an independent party as required within "Basel III-like" framework for credit institutions.

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

As mentioned above (cf. Q11 answer) we agree with the approach to use a "Basel III-like" framework in order to estimate the amount of haircut function of the 2 dimensions: type of assets and residual maturity of this asset. However, we are more favorable towards the splitting of debt products in investment grade and non-investment grade categories, in addition to the distinction between sovereign and corporate issuers.

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?

We agree that Option 1 – "High level" will reduce significantly the liquidity of the repo market and therefore will increase the procyclicality risks.

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

We do not have any additional specific factor to propose.

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?

Cf. Question 12.

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?

In line with normal market practices for trading such transactions the appropriate framework to apply numerical haircut floors should be at the collateral type level.

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.

At this stage we do not identify transactions that may cause practical difficulties.

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?

In line with market practices for trading such transactions we would recommend a monitoring at the portfolio vs. counterparty level instead of transaction 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?

We agree with the high-level principles, mitigation and stress test standards.

However, within the disclosure requirements we have the following practical issues:

- Definition of “illiquid securities” and “secured and unsecured exposures”; and
- Determining what concretely to report in term of “results of stress-tests” to investors.

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

We agree with the approach set out in Recommendation 9, however we propose that a definition of “adequate regulation of liquidity risk” is introduced to avoid confusion and/or arbitrage on this point.

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

We agree with the approach. However we stress the need to create a level playing field by including Synthetic Repo like transactions.

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

We agree with the policy recommendations described in section 4.1, subject to the creation of a level playing field with Synthetic Repo like transactions.

However we consider that the introduction of standard principles to define minimum mandatory haircuts as set out in 3.1 is sufficient to protect against the different risks. As the notion of "risky and illiquid collateral" is difficult to define/categorize a sort of double jeopardy rules may create new inefficiencies in the market with an increase of procyclicality risks as a consequence.

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