



14 January 2013

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

By email: fsb@bis.org

Dear Secretariat

**Consultative Document on a Policy Framework for
Addressing Shadow Banking Risks in Securities Lending and Repos**

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Financial Stability Board's (the Board) consultative document, *Strengthening Oversight and Regulation of Shadow Banking. A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (the Consultative Document). We support the Board's objective to ensure that shadow banking is subject to appropriate oversight and regulation, and that this objective should be met through an approach that is proportionate to the financial stability risks posed.

Any policy outcomes that result from this consultation should recognise that markets, including repo and securities lending markets, differ across jurisdictions in terms of the financial stability risks posed within domestic and global contexts. As such, any effective policy will need to be designed in a manner that encourages their implementation in a flexible way. Rigid application of one-size-fits-all rules and benchmarks runs the risk of not only applying irrelevant policies to domestic markets, but may also create distortions and inefficiencies that exacerbate financial instability.

We commend to the Board a principles-based approach; one that promotes global consistency in the regulation of systemically important markets; provides guidance to domestic regulators in assessing, measuring and regulating risks; and enables nuanced regulation that effectively targets risks that are specific to markets. We suggest that the proposals surrounding mandated minimum haircuts is not adequately targeted at risks specific to different jurisdictions, and therefore, will not effectively address financial stability concerns. As such, we caution against any proposal that would mandate numerical haircut floors.

1. About AFMA

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of over 130 participants in our exchange traded and over-the-counter (OTC) markets. These markets, including the repo market, are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk.

One of our key tasks is to promote best practice in financial markets through the sound management of Australia's \$76 trillion OTC markets. We achieve this by promoting effective self-regulation of the OTC markets through efficient and ethical market practices, conventions and standard documentation.

AFMA maintains the *Repo Market Conventions* that streamline market practices for the dealing, confirmation and settlement of repo transactions. These conventions were developed and kept up-to-date by AFMA's Repo Committee, which incorporates representatives elected by market participants every two years. The market conventions maintained by AFMA complement formal regulation of financial markets.

Given our role in supporting the efficiency of the Australian repo market, the proposals in the Consultative Document in relation to repo markets are of specific interest to our membership. Our submission focuses on the proposals in relation to repo markets.

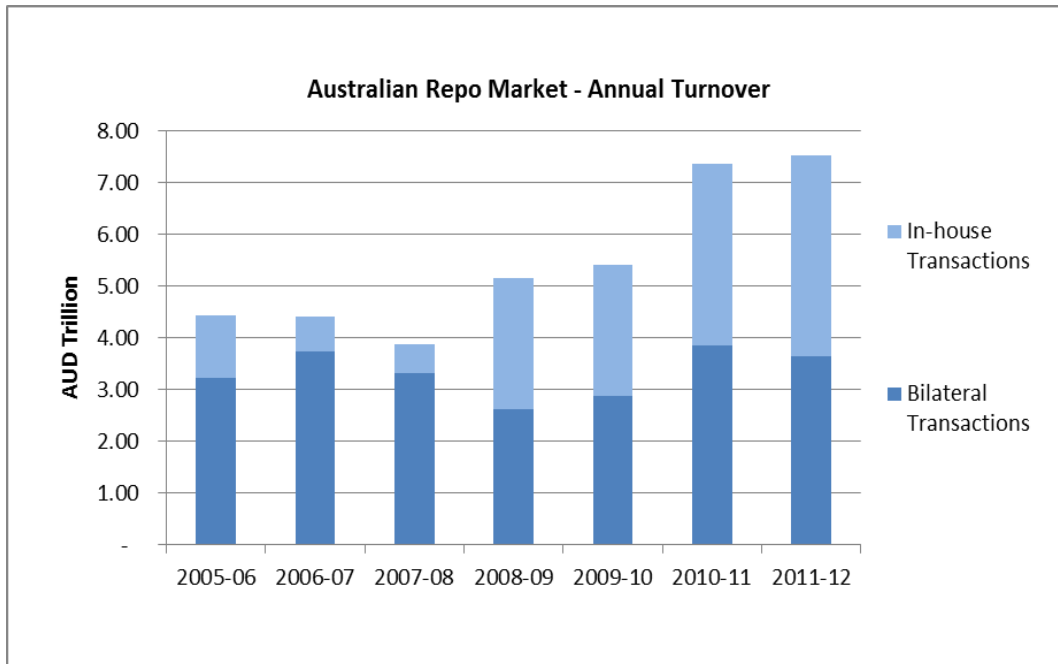
2. The Australian Repo Market

The Australian repo market is dominated by trades between Authorised Deposit-taking Institutions (prudentially regulated banks) purely for liquidity reasons and those dealt by securities dealers (most of which are part of a bank-regulated group) to manage their long and short trading positions. Repo transactions are also undertaken by the Reserve Bank of Australia (RBA) as part of its daily open market operations. As such, the Australian repo market plays a vital function in the transmission of monetary policy, provides an efficient source of money market funding for financial intermediaries, and supports liquidity within securities markets.

AFMA compiles an annual survey of turnover on financial markets in Australia. This survey, the *Australian Financial Markets Report*, is the only comprehensive publication on the size of exchange traded and OTC markets in Australia. For the repo market, the survey collects data from 11 survey respondents who are the most active participants in the market.

The 2012 *Australian Financial Markets Report* shows that there was a total turnover of \$7.5 trillion (AUD) in the Australian repo market over the year ending 30 June 2012, including in-house transactions. Bilateral volumes have steadily grown since the global financial crisis (notwithstanding a slight decline in 2011-2012) which is reflective of the important role of the market in stabilising liquidity during the crisis, and the subsequent enhanced role of collateralised funding (see **Graph 1**).

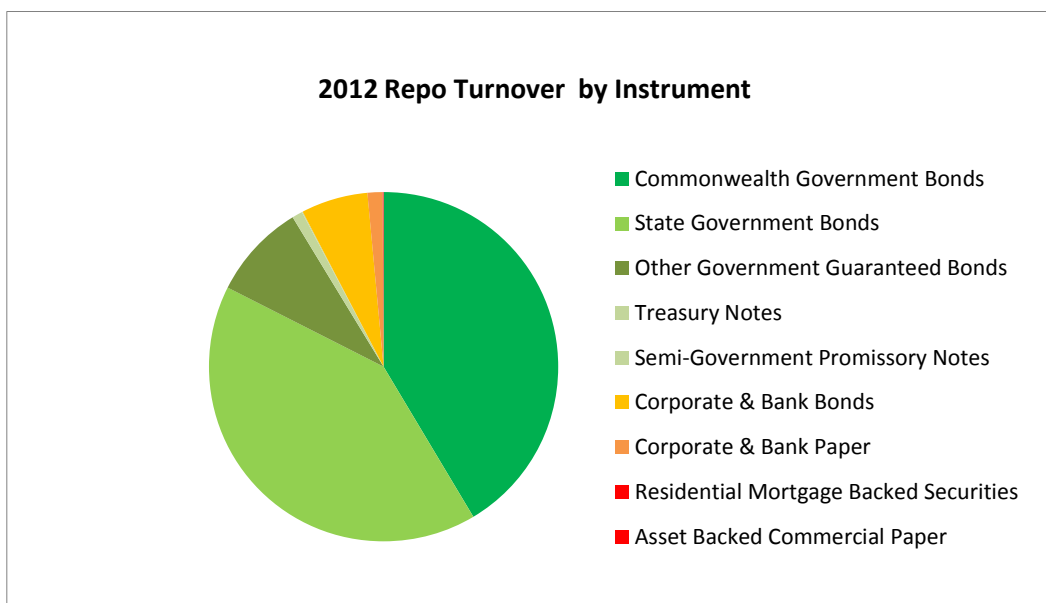
Graph 1



Source: Australian Financial Markets Association (2012), *Australian Financial Markets Report*

Over 2011-12, 84 per cent of repo transactions were collateralised with Commonwealth and State government securities (see **Graph 2**). Another 9 per cent of repo transactions were collateralised with government-guaranteed bonds. Overall, general collateral (GC) securities underpinned 92 per cent of repo transactions over this period, clearly demonstrating that the quality of collateral used in the Australian repo market is of the highest quality. Furthermore, excluding in-house transactions, outstanding repos against private securities totalled only \$5 billion (7 per cent of total bilateral outstanding repos), of which 40 per cent were contracted with the RBA.

Graph 2



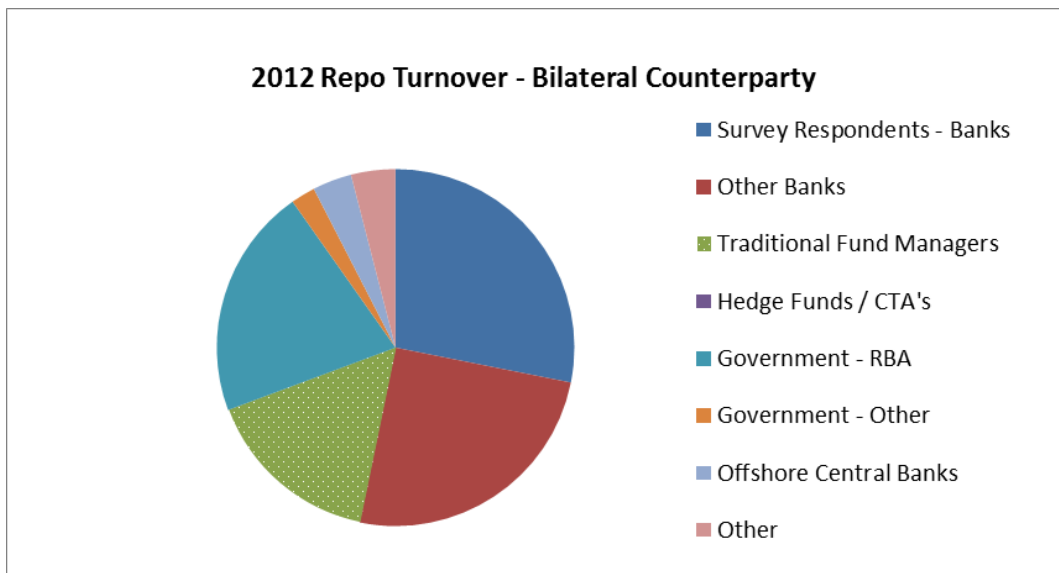
Source: Australian Financial Markets Association (2012), *Australian Financial Markets Report*

Market practice, as set out in the *Repo Market Conventions*, is for general collateral (GC) securities to be tiered; GC 1 includes government securities that are most liquid such as actively traded AUD Commonwealth government (federal) and Semi government (state) bonds; while GC 2 includes other government-related securities that are less actively traded. GC 1 repos trade at lower repo rates than GC 2 repos. Amongst market participants it is not common for haircuts to be applied to either GC 1 or GC 2 transactions.

As noted, the majority of repo transactions in the Australian market are conducted between prudentially regulated banks. All of the survey respondents to the AFMA survey are banks regulated by the Australian Prudential Regulation Authority (APRA). The results of the survey indicate that 76 per cent of bilateral repo trades in Australia are transacted between banks, or between banks and government entities (see **Graph 3**). The remainder of transactions are those between survey respondents and traditional fund managers (16 per cent); offshore central banks (4 per cent); and other counterparties (4 per cent).

For transactions between survey respondents and the other counterparties likely to include unregulated entities, the overwhelming majority of repos transacted at 88 per cent are underpinned by GC. Overall, the data suggests that unregulated entities play a very insignificant part in the activities of the Australian repo market, and transactions with such entities are generally secured by the highest quality collateral.

Graph 3



Source: Australian Financial Markets Association (2012), *Australian Financial Markets Report*

Over the course of the financial crisis, the repo market played a significant role in enabling the RBA to effectively manage and maintain market stability. The RBA was able to utilise its pre-existing framework for market operations flexibly to respond to issues as they arose, for example, by providing greater certainty to longer term funding by increasing the term of repos available to market participants and expanding the range of eligible collateral to AAA-rated paper.

3. Market Transparency and Improvements in Regulatory Reporting Recommendations 1 - 5

We agree with the Board that increased transparency has the potential to provide useful information to authorities that can help to detect and monitor risks as they unfold. To adequately manage financial system stability, regulators and authorities need to be fully informed of market developments and trends as they arise. From our perspective, the proposals in relation to enhancing transparency in repo markets in the Consultative Document have the most potential to meaningfully enhance existing regulation of the market.

We encourage the Board to consider efficient means to enhance market data collection and its analysis to enable a more informed assessment of financial stability risks in repo markets, before any substantive regulatory policy decisions are made.

As previously noted AFMA collects and publishes aggregate market data for the Australian repo market and includes these data categories included in Box 1 of the Consultative Document:

- Size of market activity
- Tenor composition by collateral asset class
- Collateral composition by asset class
- Breakdown of counterparties and concentration

Since 2010, the RBA has also conducted a quarterly survey of key market participants on their aggregate repo positions against government-related securities and the types of counterparties with which these participants deal, although the results of these surveys currently are only made publicly available on an irregular basis. Generally however, the market has been receptive to initiatives to enhance market transparency.

Data collection paves the way for tackling six key issues identified by the Board related to securities financing markets, namely the pro-cyclicality of system leverage and interconnectedness, potential financial stability issues associated with collateral re-use, potential risks arising from the fire-sale of collateral assets, the potential risks arising from agent lender practices, securities lending cash collateral reinvestment and insufficient rigour in collateral valuation and management practices.

However, there needs to be a distinction made between the distorting effect of post trade transparency in an inherently bilateral market and that of data collection for regulatory purposes. For regulators a more detailed information set provides insights that may help them to identify trends in the build-up of risks over time, either for a specific institution, a specific asset class, or for the market overall. Enhanced regulatory data also allows regulators to monitor changes in market activity that can lead to the emergence of potential new risks and to support the development of appropriate policy responses in times of stress. These regulatory objectives can be met through enhanced data collection by regulators, but need not result in any material changes to post trade transparency.

In the case of repo, and contrary to other financial market segments, plenty of relevant data of interest to central banks are already channelled from the trading layer for execution to various categories of intermediaries to the payment, clearing and settlement systems. How this set of highly critical but dispersed data can be adjusted, formatted, complemented if necessary, and channelled, to form the much needed central view on the market needs to be considered. For example, the efficient input and retrieval of data by whom and to whom, and under what governance and technical channels need to be considered. As well, questions surrounding what shall be the indispensable confidentiality requirements to ensure an appropriate level of data disclosure taking into account the needs of authorities and different stakeholders are critical. Much work is already ongoing with regard to developing derivatives trade reporting, and consideration of repo market data collection needs to leverage off this existing work.

Access to collected transaction data should be granted to all regulators on the same terms. Trade repositories should operate under a regulatory regime with appropriate data protection safeguards. Besides appropriate data protection safeguards, other important issues to be solved are access, location, governance and regulation.

From an Australian law perspective the Commonwealth, State and Territory Privacy Acts serve as data protection laws which regulate the collection, use and disclosure of personal information about individuals. A variety of other legislation contains privacy protection provisions relevant to particular types of entities and/or practices, for example, the Spam Act, surveillance and listening devices acts, and many others.

Data being submitted to trade repositories is being done for the public policy reason of assisting regulators understand market dynamics. Consistent with the position in other jurisdictions, reporting entities should retain intellectual property rights in data submitted to a trade repository, including in data that is maintained by a trade repository that is not released publicly under statutory requirements.

Given the confidential and sensitive nature of the information contained within trade repositories, data should only be provided to regulators in direct support of their regulatory mission. Therefore, for example, the level of granularity of data that is appropriate to provide to central banks and prudential regulators might differ to that which is appropriate for a trade repository to provide to a market regulator.

Information disclosed to the public by a trade repository should be on an aggregated level. Furthermore we also believe that such data would, by definition, be made anonymous. This establishes the fundamental principle of public reporting; that it should not be possible, from the information provided, for any party to calculate or imply any positional or trade related information pertaining to a particular market participant, either directly or indirectly.

Although greater disclosure may bring benefits both to the regulators and to the market, we would encourage policy makers to balance this carefully against the cost of any

additional reporting. In particular any move towards the creation of a repo trade repository would need to be justified by a robust cost-benefit analysis.

4. Regulation of Minimum Haircuts – Recommendations 6 and 7

We are strongly opposed to any proposal that would mandate minimum numerical haircuts for the repo market, given the need for more empirical analysis on the relationship between collateral haircuts and financial stability. Such an analysis needs to be conducted at the domestic market level, given the diversity in size and characteristics of repo markets in different jurisdictions.

We strongly believe that any decision to introduce minimum standards for the methodologies that firms use to calculate collateral haircuts must be maintained within the domain of the jurisdictional regulator. No two jurisdictions share the same characteristics, and Australia's repo market is quite unique inasmuch that the very great majority of transactions are collateralised with government-related securities which themselves are Basel III liquidity standard level 1 assets. The Basel Committee, recognising the unintended consequences which may flow to jurisdictions from the implementation of global regulations, already allows for specific compromises within jurisdictions to address idiosyncratic risks posed by global regulations. The point here is that well regulated and managed jurisdictions should maintain regulatory autonomy when it comes to determining minimum standards and methodologies that the greater majority of market participants could or will use to calculate collateral haircuts. Absent this, jurisdictional nuances have the potential to be overlooked which may result in impacts on the liquidity of the repo market which would quickly have flow-on effects to the economy of the jurisdiction.

Much of the academic material that establishes a link between haircuts and financial instability referenced by the Board in its Interim Report, *Securities Lending and Repos: Market Overview and Financial Stability Issues*, were based on the experience of the US repo market, which has a very different structure to the Australian, European and Asian markets. Haircuts are not a feature of the vast majority of repo transactions in Australia, due to the high quality of collateral and counterparties in the market. Over 90 per cent of collateral in the Australian repo market is government-related securities, and Basel III level 1 assets. Structured securities are a small component, with residential mortgage backed securities and asset backed commercial paper comprising just 0.1 per cent of collateral used in repo transactions during 2011-12.

The repo market is one of the most active sectors in Australia's money markets, providing an efficient source of money market funding and an essential monetary tool for the RBA. Our members concur that globally imposed minimum haircuts, even at the backstop levels proposed in option two in the Consultative Document, given the minimal use of haircuts currently, will significantly drive down liquidity in the market. In Australia, this contraction in liquidity will be exacerbated by the limited volume of other sources of domestic funds.

AFMA will maintain a dialogue with the RBA and its representative working with the Board on this matter and would be pleased to provide further comment through this channel if desired. Please contact Denise Hang dhang@afma.com.au or myself mregan@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Murray Regan', with a stylized, cursive script.

Murray Regan
Director – Markets and Rates