

Position Paper

Madrid, January 2013

BBVA response to the FSB consultative documents on shadow banking

General Remarks

- BBVA congratulates the FSB for its continuous work towards better regulation and supervision of the financial markets. We consider that the current work by the FSB, BCBS, IOSCO and other authorities, following the G20 mandate, dealing with risks posed by the shadow banking system, and strengthening its oversight and regulation is essential to complement the ongoing reform of the banking regulation, the financial markets infrastructures and the OTC derivatives markets, favoring a global and consistent framework. Needless to say, a comprehensive approach and a full coordination of financial authorities are essential to achieve this goal so we very much welcome all the efforts done at the global level in order to ensure that international coordination and policy consistency will prevail across jurisdictions.
- We have long advocated for the need to have a better oversight and regulation of the shadow banking system in order to mitigate, not only systemic risk, but also the competitive distortions that might arise as a result of existing regulatory arbitrage opportunities. In this sense, the authorities should seek to minimize the risk of circumvention of banking regulatory reform by shifting a business activity to a sector less regulated or less supervised. The final end should be to preserve financial stability while at the same time maintaining a level playing field that is based on genuine competitive advantages.
- BBVA has worked in close cooperation with the Institute of International Finance (IIF) analysing this document and elaborating a response, which we broadly support. Nevertheless we would like to make a few individual comments that we include in this position paper.
- BBVA has long been actively calling for a definition of shadow banking that is based on activities rather than entities. We have also widely defended that the same prudential regulation should apply to the extent possible to all bank-like activities. In this sense, we are satisfied with the general approach presented by the FSB, focused on activities whenever possible and appropriate. However, there are still a lot of details to be disclosed in relation to the concrete form that the different recommendations of the FSB and the other agencies involved might take in the final FSB recommendations, and we would like to have the opportunity to comment on them in a further consultation.
- We also look forward to see and comment on proposals from the Workstream 1 on indirect regulation, led by the BCBS. We call the FSB and the BCBS to submit the interim recommendations of this Workstream to public consultation, trying to avoid unnecessarily short response times that hinder a proper analysis to the detriment of the quality of the answers by the industry and other stakeholders.

- Given the complexity of the shadow-banking system, the achievement of a deep understanding of the multiple activities involved in it, with their complex interrelations and indirect connections with the banking system, poses a big challenge. But the effort is unavoidable if we are to identify the best policies in order to mitigate risks in an efficient and proportionate manner. The current policy process, which comprises five specialized work-streams, is a way to partially deal with this complexity but, at the same time, it entails the risk of a lack of consistency of the proposals if the different work-streams are not coordinated enough which may hinder a lack of a global view that takes interrelations into account.
- We therefore consider that an additional effort is necessary in order to ensure consistency and to avoid that several measures are imposed to the same activity in an uncoordinated way and without the estimation ex-ante cumulative impact. Accordingly, an adequate opportunity for both regulators and interested parties to consider proposals as a whole is necessary and a comprehensive revision should be convenient to ensure consistency with the ongoing wider financial reform process. For instance, securitization is being treated in several Workstreams (1, 2 and 4) and the consistency of approaches taken should be assured. Moreover, the recent consultation by the BCBS on securitization which deals with aspects others than those proposed by the FSB should be assessed in combination. Nevertheless to say that a comprehensive view, that encompassed the extensive changes that securitization has experienced since the crisis both as a result of market forces and regulation, is essential before determining the convenience of additional changes.

Specific Remarks

- We welcome the proposed two-step process in approaching the monitoring of the shadow banking system as it allows undertaking a comprehensive monitoring both in and out of the regulated banking perimeter. BBVA has long advocated for the extension of the regulatory perimeter to the shadow banking system in order to mitigate systemic risks and undue competitive distortions. For that reason, we consider that besides the focus on systemic risks, authorities should also be aware of competitive distortions arising from the fact that some bank-like activities in the shadow banking are not subject to the same prudential requirements than regulated banks performing the same activity or function.
- As the FSB quite rightly points out, the ongoing strengthening of the capital and liquidity requirements applying to banks may increase the incentives for some bank-like activities to migrate to the non-bank financial space. To identify these risks and to apply the necessary measures, we consider that system-wide monitoring arrangements are necessary and we welcome the proposed two-step process that allows filtering in all non-bank credit intermediation with a demonstrated potential to pose bank-like systemic risks. For this monitoring, when designing new data requirements, the authorities should carry out a cost-benefit analysis and, in doing so they should consult the industry in order to achieve the most cost effective way to gather the required information.
- BBVA considers very useful the annual monitoring exercise conducted by the FSB through its Standing Committee on Assessment of Vulnerabilities (SCAV). After conducting its second exercise, one of the conclusions is the need for significant improvements in data availability and granularity to adequately capture the magnitude and nature of risks in the shadow banking system. For this monitoring, when designing new data requirements, the authorities should carry out a cost-benefit analysis and, in doing so they should consult the industry in order to achieve the most cost effective way to gather the required information.

- Regarding WS1, on Banks' interactions with shadow banking entities, our assessment is pending of the future publication of BCBS' detailed proposals. In particular, we think that a key issue to be dealt with under this Workstream is how protecting banks against the risks posed by shadow banking system. As the consultative document on the integrated approach rightly points out, the measures should be designed to ensure an appropriately risk sensitive and consistently applied risk-based capital regime. These measures should avoid increasing excessively prudential requirements on banks as a mere way of indirectly mitigating the risks posed to the financial system by the shadow banking as this would encourage more activity to move outside of the regulated banking sector, also hindering competition to the detriment of the regulated banking activity.
- As for WS2, on Money Market Funds, BBVA endorses FSB's and IOSCO's recommendation that stable Net Asset Value (NAV) MMFs should be converted into floating NAV where workable. Where such conversion is not workable we agree largely with FSB's position that they should be subject to liquidity and capital requirements similar to banks.
- **Regarding WS5, on securities lending and repos**, for which a separate consultation has been opened on the document "Strengthening Oversight and Regulation of Shadow Banking: A Policy framework for Addressing Shadow Banking Risks in Securities Lending and Repos", we regret the very short consultation period that is hindering the ability to provide more detailed responses to the FSB questions and constructive alternative approaches that are also in line with the FSB objectives. Securities financing markets are complex and rapidly evolving and they can be opaque for some market participants and policymakers, mainly due to their main bilateral nature. The proposed creation of Trade repositories is a good way to improve transparency and we fully endorse it as long as a good design prevails (in terms of scope and standardization) and data is conveniently aggregated before it is publicly released or shared with other regulators. The ECB proposal to create a European Repo Database represents a step forward in the right direction in order to strengthen both the transparency and the supervisory oversight. However, we have more reservations on the section on minimum haircuts. Apart from the case of structured securities it has not been sufficiently proven that haircuts are procyclical for most collaterals. As the BIS Committee on the Global Financial System (CGFS) has already reported,¹ the drop in liquidity during the financial crisis was driven by traditional reactions to heightened risk perceptions, as is the withdrawal or contraction of credit lines. Clearly, a minimum mandatory haircut would not stop this type of response, a point conceded by the CGFS itself. Accordingly, serious doubts are raised on the effectiveness of proposed measures on haircuts (mandatory more stable and high haircuts, subject to a minimum) in order to mitigate in a substantial way the observed procyclical behavior of these markets. Therefore, we urge the FSB to take into account the following considerations:
 - The **minimum standards proposed for the methodology to be used by market agents** provide a fair estimation of counterparty risk and, as such, they **should only be used for capital adequacy purposes**. In fact, a methodology of this kind, though with some material differences, is already in use to calculated capital charges on counterparty risk for institutions subject to Basel requirements.
 - The **use of this methodology to determine minimum haircuts may lead to undesired consequences** such as;

1: BIS Committee on the Global Financial System (CGFS). The role of margin requirements and haircuts in procyclicality. Paper No.36. March 2010.

- An increased reliance of banking institutions on central bank funding. In cases when the minimum haircut is higher than those applied for central banks, banking institutions will be incentivized to search funding from central banks instead of approaching the financial markets.
- An increase in the counterparty risk for the cash receiver of the transaction on the event of default of the counterparty receiving the security.
- We think that **minimum regulatory haircuts should not be higher than those imposed by central banks for similar transactions**. A higher haircut on transactions might force banks to maximize their use of repo and other securities financing transactions with central banks, and reduce their transactions with other market participants. Numerical floors should only be set for instruments that are not eligible for collateral purposes at central banks.
- On **collateral cash-reuse** BBVA agrees to restrict the imposition of minimum standards for cash collateral reinvestments to non-bank entities. BBVA also considers that these minimum standards should apply only to the reinvestment on cash received on the lending of illiquid and/or highly risky securities; we consider that there is a small risk that an entity suffers a loss when it has received a liquid and low risk security in a repo or security lending transaction, as this entity would be able to sell the security at a price close to the cash sent to the counterparty.
- Regarding **re-hypothecation practices**, BBVA agrees that only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of their client assets. It also agrees on the need to ensure authorization from clients and/or a sufficient disclosure to clients in relation to the involvement in such practices and the risks they entail.
- On **collateral valuation**, BBVA considers that daily mark-to-market and daily margin adjustments should not be required. However, daily margin revaluation could be workable in cases when minimum thresholds are set at acceptable levels.
- Regarding the **recommendations relative to more structural aspects**, BBVA agrees that sufficiently strong incentives to use the CCPs framework are already in place for inter-dealer repos against safe collateral. BBVA considers that the use of CCPs should only be incentivized for the purpose of reducing systemic risk. For this reason, it does not consider appropriate to encourage the use of CCPs for market participants that do not pose any systemic risk and/or for securities that are not commonly used in repo transactions.

Next steps

- Due to the complexity of this topic, the sequential nature of the subsequent consultations that have been opened we consider that an additional public consultation should be carried out on the recommendations from each work-stream and the integrated FSB strategy before the FSB issues its final set of recommendations in order to avoid any lack of consistency and/or overlapping.