January 14, 2013

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland
fsb@bis.org

Dear Sir/Madam,

Re: Canadian Bankers Association (CBA)[1], Investment Industry Association of Canada (IIAC)[2], and Canadian Securities Lending Association (CASLA)[3] Comments on the Financial Stability Board's Consultative Document: Strengthening Oversight and Regulation of Shadow Banking (A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos)

Thank you for the opportunity to comment on the Financial Stability Board's (FSB) Consultative Document: Strengthening Oversight and Regulation of Shadow Banking (A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos). The Canadian Bankers Association, the Investment Industry Association of Canada, and the Canadian Securities Lending Association (the "Associations") collectively represent financial institutions that account for the majority of securities lending and repo activity in Canada.

Given the importance of the securities lending and repos market to the broader financial system, we support global measures designed to protect the integrity of these markets and that do not detract from their ability to function efficiently. The Associations, therefore, acknowledge the FSB's efforts to dampen risks and pro-cyclical incentives associated with secured financing contracts such as repos, and securities lending that may exacerbate funding strains in times of "runs".

The Associations encourage the FSB to align any policy measures ultimately taken in this area with the Basel III capital and liquidity requirements to ensure consistent regulatory treatment of

[1] The Canadian Bankers Association works on behalf of 54 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 274,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

[2] The Investment Industry Association of Canada is a member-based professional association with 175 member firms representing Canada's securities industry. IIAC members represent the vast majority of securities underwriting and trading in Canada.

[3] The Canadian Securities Lending Association is an industry representative body that promotes efficient markets and best practices. CASLA serves the interests of beneficial asset owners, securities lenders, and borrowers by working with self-regulatory organizations and regulators as well as seeking to educate and enhance market participants understanding of the securities lending industry to ensure its long term viability.

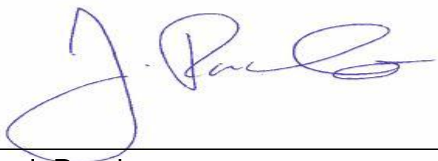
the securities lending and repos market. We note that Canadian banks fully adopted the Basel III capital requirements of 2019 on January 1, 2013, forgoing the six year phase-in period.

The Associations are concerned with the potential impact that some of the proposed recommendations and measures in the document could have on the securities lending and repos market, and the corresponding markets they support, in terms of liquidity, competition, and privacy. For example, as a core funding market, any changes to the repo market could impact the functioning of other markets. These concerns are elaborated further in the attached table, which contain our responses to the specific questions contained in the consultative document.

We thank you for taking our comments into consideration and would be pleased to discuss these issues further at your convenience.

Sincerely,

Marion Wrobel
Vice-President, Policy & Operations
Canadian Bankers Association



Jack Rando
Director, Capital Markets
Investment Industry Association of Canada

Reeve Serman
President
Canadian Securities Lending Association

CBA, IIAC, and CASLA Comments on the FSB's Consultative Document: Strengthening Oversight and Regulation of Shadow Banking (A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos)

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.

The consultative document, taken together with the earlier interim report, largely identifies the financial stability risks in the securities lending and repo markets. However, we believe that the consultative document and interim report does not sufficiently address the liquidity and credibility of government bond markets for primary dealers. It is important to distinguish between sovereign debt securities and other securities, as risks pertaining to collateral valuation (e.g., the risk of a fire sale of collateral securities) would tend to be less pronounced or virtually non-existent with sovereign debt securities. Therefore, the Associations believe it would be appropriate to exempt primary dealers from any regulatory measures in this area in order to maintain their role in supporting market integrity for sovereign debt markets.

Securities lending and repos are an integral part of ensuring that government bond markets are both efficient and credible. This could be addressed through stratifying both assets and counterparty types. For institutions with access to liquidity provided by the central bank, we believe that the assets acceptable as collateral for those central bank facilities should be exempt from haircut requirements and be addressed through appropriate liquidity requirements for those institutions.

We would like to note that much of the recent growth in the securities lending and repos market has primarily been a result of increasing government deficits and not a result of increasing leverage in government bond markets.

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?

In addition to our response to Q1, we offer the following comments.

The securities lending and repos market in Canada is well regulated, mature, and efficient, and has performed well under stressed market conditions (as demonstrated during the financial crisis of 2007-2008). We believe that the FSB and national authorities should take into account the effectiveness of existing domestic regulations and practices, as well as the Basel III capital and liquidity requirements, prior to implementing any new regulations and requirements, and should ensure that any new regulations continue to support efficient and liquid markets. The Associations would also like to note that overly prescriptive regulation could be unnecessarily costly and counterintuitive, in the sense that it could reduce market efficiency by causing some institutions to exit the market.

In certain jurisdictions, regulatory limitations on outright leverage may act as a governing mechanism over securities financing. For example, the U.S. Investment Company Act of 1940 imposes outright leverage restrictions on mutual funds. Consequently, any regulations in this area must be able to determine if specific securities lending or repo transactions would be categorized as a use of outright leverage or otherwise.

In addition, although the recommendations take into consideration liquidity risks (e.g., cash collateralized securities lending), they do not specifically note maturity mismatch risk. It is not clear whether this risk is captured under liquidity risks.

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?

The Canadian banking industry is currently undergoing the largest regulatory implementation exercise in its history. One of the most significant changes has been the full implementation of the Basel III capital requirements (i.e., the capital requirements of 2019) by January 1, 2013, six years earlier than required. Canadian banks are also preparing for the implementation of the Basel III Liquidity Coverage Ratio, the Net Stable Funding Ratio, as well as increased liquidity disclosures. These major changes will have a direct and indirect impact on the securities lending and repos market in Canada.

The Canadian securities industry is also undergoing significant structural reforms. Specifically, the recent introduction of a new fixed-income (repo) central counterparty facility and its designation from Canada's central bank as systemically important infrastructure has resulted in an increasing number of repo transactions to be centrally cleared and netted.

The Associations request that before any changes are made to the securities lending and repos market, the FSB consider whether the numerous other regulatory and structural changes that have taken place (and that will take place in the future) already address the FSB's concerns over shadow banking. Further, the Associations emphasize the need for the FSB to consider the potential inconsistencies that could occur across jurisdictions and market participants, and any unintended consequences that may arise, as a result of changes to the securities lending and repos market.

For example, the establishment of a numerical floor on haircuts would be a material change for the securities lending and repos market in Canada, as currently haircuts tend to be generalized across major asset classes and aligned with the regulatory capital framework for each institution. Further, for repos that are centrally cleared, the CCP has established haircuts that it deems appropriate.

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.

We believe that most of the benefits that would accrue from implementing these recommendations would be largely towards greater overall financial stability rather than to any particular institution. It is unlikely that institutions would receive any financial benefits from implementing any of the proposed policy recommendations. And while we cannot quantify the

costs of implementing these recommendations at this time, we expect that these costs would be high.

We would like to note some of the potential unintended consequences that could arise:

- a greater separation (the creation of silos) between the shadow banking and banking system as banks may look to avoid the additional regulation that would result from transacting with shadow banking entities;
- measures taken to reduce outright leverage could impact the liquidity of collateral from a trading and market making perspective;
- an un-level global playing field as regulations are not applied consistently across jurisdictions;
- an exit of market participants as existing business models become less viable; and,
- a reduction of market liquidity as a result of reduced competition.

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)?

It is difficult to comment on the appropriate phase-in period to implement the policy recommendations as the recommendations have not yet been finalized.

However, we would like to note that the appropriate length of any phase-in period should take into consideration the numerous other reforms currently underway (or that will take place in the near future). This is important to ensure: resources at financial institutions are available to implement the globally accepted reforms to the securities lending and repos market; and, no duplicative or contradicting requirements are placed on financial institutions.

The Associations request that the FSB consult with industry on the appropriate phase-in period once any recommendations have been finalized and that the implementation of any recommendations be done in a consistent and uniform manner across jurisdictions to ensure a level playing field globally.

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.

Given that many repo and securities lending market participants operate globally, we are generally supportive of a globally harmonized framework for data collection. However we have serious concerns with some of the items listed in Box 1. As a general matter, we believe that the proposed list of information items is too extensive and that certain items would be difficult to provide.

We believe that the information of most value to regulators should be related to tenors and volume. This information is also generally more readily available and could, perhaps, be more easily provided by market participants. However, we believe that such information should only be provided to regulators on a confidential basis, as public disclosure would reveal institutions' proprietary information to competitors. The public disclosure of such information could result in

some firms exiting the market, which would result in reduced market liquidity.

Re-use and re-hypothecation data in particular would require increased clarification to ensure consistency in approach and assumptions used in collecting data, and potentially considerable technology development to support the reporting, depending on the scope.

We would also like to caution against the analysis of this data for regulatory purposes without the appropriate context. The complexity of the securities lending and repos market limits the value of such information items when interpreted out of context (e.g., “repo rates” are determined according to a number of factors, such as transaction size, the haircut applied, etc., and haircuts are determined according to a counterparty credit analysis, asset class, etc.)

Given that regulatory reporting is already largely done by market participants, it might be beneficial to explore whether regulatory reporting should be done on a country by country basis or whether it should be amalgamated at the parent level (i.e., parents and affiliates contribute to a common report). Any globally harmonized data collection framework should strive to ensure that global businesses are not caught up in multiple chains of duplicative reporting.

The Associations also seek greater clarity on how frequently this information would be reported and how any information provided by market participants would be protected.

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?

The Associations believe that the most effective way to collect comprehensive market data for securities lending and repos – at least initially – is for the FSB to coordinate a set of market-wide surveys by national/regional authorities. Such a survey, however, would have to be properly structured. We believe that a properly structured survey could help form the design of a long term data collection approach such as use of TRs, and facilitate the necessary cost/benefit analysis before pursuing the long term approach. The Associations believe that before moving to a TR approach, it must be demonstrated that the benefits of such an approach over a survey approach would exceed the costs (financial and time) to build TRs.

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?

Some of the issues we believe authorities should be mindful of include:

- different legal regimes across jurisdictions;
- the need to respect national privacy laws and ensure client privacy;
- the need for consistency across reporting participants and jurisdictions;
- the global pace of adoption of legal entity identifiers;
- security of data; and,
- the cost and time to implement.

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 support sound and reasonable corporate disclosures of an entity's investment or financing activities. This, however, is best administered through the existing accounting standard-setting bodies such as the IASB and FASB. As such, we would suggest that discussions take place with these bodies. The Associations believe that the enhanced disclosure items listed may be useful for authorities but do not agree with the disclosure of all such items to market participants. We believe that the disclosure of certain data and information would reveal proprietary information to competitors, which could reduce competition in the market and consequently market liquidity. The qualitative disclosures listed in the consultation document would entail significant work. Further, the provision of some of the listed items may be difficult to isolate given that repo market participants generally deal with lenders en masse (e.g., to maximize efficiencies through tri-party pools). We would also like to reiterate the importance of regulators analyzing and interpreting this data and information in the appropriate context. Examination of such data and information without such context could lead to incorrect conclusions and possibly inappropriate policy responses. We also note that it is difficult to determine the liquidity of counterparty portfolios (e.g., broker-dealer counterparties).
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 Associations believe that the disclosure of the listed items would be of little benefit to most Canadian investors. There are already strong controls in place for regulated Canadian funds and we believe that the disclosure of the listed items would not be meaningful for Canadian investors. Further, increasing the level of disclosure along the lines contemplated in the consultative document would run contrary to recent mutual fund industry reforms in Canada that are aimed at providing fund investors with simpler or more easily digestible information pertaining to their fund holdings.
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? ***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?

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?

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?

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?

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.

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 Associations strongly believe that any approach that would apply minimum haircuts on a transactional (i.e., transaction-by-transaction) basis is flawed. Instead, the Associations believe that any haircuts should be applied on a portfolio basis. Further, the haircut framework should differentiate among bilateral, tri-party, and centrally cleared transactions. We also believe that there is little benefit in imposing minimum haircut floors. Instead, the level of any haircut should be determined on a daily basis and be flexible enough to accommodate extenuating circumstances when it comes to haircutting a customer or an asset type. Implementing a standardized matrix for haircuts would require more extensive consultation with industry and should also have some level of flexibility to accommodate transactional nuances.[4]

The proposed haircut framework on a transactional basis does not account for the correlation of collateral and loans (which would include a VAR calculation that takes into account concentration risk, any currency and asset class mismatch, potential liquidity premiums for certain assets, and historical price volatility of both loan and collateral pools), diversification, price transparency, the liquidity of collateral pools, the counterparty credit status, and the counterparty legal status (regulated or unregulated). The Associations believe that market participants should have the flexibility to determine the appropriate haircut based on the above mentioned factors.

In addition, onerous haircuts, in particular the haircuts proposed for equities in Option 1 and Option 2, could introduce other unintended impacts, including increased risk. For example, firms pledging collateral would have an unhedged exposure to another financial institution, which may further impact flows and related liquidity and could further perpetuate illiquidity and lock down in a stressed market situation.

[4] To illustrate the challenges of implementing a globally standardized matrix for haircuts, members view the 4% haircut on sovereign debt greater than 5 years (as depicted on the numerical floors matrix on page 14 of the consultative document) as being too high, which could adversely impact liquidity in Canadian repo markets.

In contrast, applying haircuts on a portfolio basis would ensure that the relevant risks are captured appropriately and would also incent proper behavior by market participants.

We would also note that a new fixed-income (repo) CCP was recently introduced in Canada which essentially applies numerical haircut floors. In addition, the Bank of Canada also applies minimum haircuts for collateral provided under its liquidity facilities. Consequently, we believe that numerical haircut floors imposed by national authorities in Canada would be of little additional value.

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 Associations believe that the primary responsibility of the reinvestment of cash collateral by securities lenders must be principal protection, in regular and stressed market conditions. Securities lenders that reinvest cash collateral must have reinvestment policies and guidelines in place, have clear (and signed) contractual reinvestment requirements in client agreements, appropriate risk management oversight of cash pools, and controlled maturity mismatch that will stand up against large, unexpected withdrawals. The Associations support the principles of pricing integrity, daily valuation, full transparency, and the management oversight of liquidity risk (duration risk) of the cash pools to protect against large, unexpected withdrawals. We also support the reinvestment and reverse repo activity for cash pools.

The Associations do not support the proposed minimum standards related to specific assets classes, funds, or investment vehicles, nor specific reinvestment guidelines of time horizons (as clients may choose to take a long-term view on an industry or asset class, etc.).

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

With regards to the first bullet of Recommendation 9, the Associations believe that a required disclosure to clients in relation to re-hypothecation of assets would be impractical and unnecessary. Instead, we believe that a more effective approach would be for market participants to discuss, and document, their re-hypothecation practices and procedures generally with clients, for example, during the client onboarding process. This could be further supported in the documentation governing the client relationship. In addition, we note that information pertaining to re-hypothecation is already commonly disclosed by Canadian market participants in the GMRA's or Credit Support Annexes executed with clients.

We also seek greater clarity on the meaning of "client assets". Specifically, we would like to clarify whether the term refers to fully paid for segregated client assets, assets that are purchased on margin, or assets provided as collateral in repo transactions (in which case market participants already typically have agreements that provide the legal right to re-hypothecate). This would be an important clarification in developing a harmonized framework for re-hypothecation.

The Associations would like to highlight the importance of allowing financial market participants to manage their liquidity through the reuse of collateral. The reuse of collateral supports the liquidity of market participants and the liquidity of financial markets, which consequently contributes to the stability of the financial system.

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?
In Canada, these minimums standards are currently being met by market participants as part of their prudent risk management practices. Under the current Basel capital framework that applies to Canadian banks, these minimum standards are also required for an institution to benefit from netting for capital purposes. We believe that the additional capital requirements assessed against non-netted positions provides sufficient incentive to ensure that these minimum standards are met without imposing them as mandatory minimum standards.
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?
A cost benefit analysis is key to ensuring the appropriateness of establishing a CCP, its expansion, and ongoing viability. The Associations note that the policy recommendations in sections 4.1 and 4.2 are not firm recommendations, but rather advice to authorities on activities to undertake regarding the structural aspects of securities financing. We would generally support the recommendation in section 4.1 but note that in smaller markets, the additional costs of introducing a CCP could introduce inefficiencies into previously efficient markets. The Associations support the recommendation in section 4.2.