C L I F F O R D
C H A N C E

CLIFFORD CHANCE LLP
10 UPPER BANK STREET
LONDON
E14 5JJ
TEL +44 20 7006 1000
FAX +44 20 7006 5555
DX 149120 CANARY WHARF 3
www.cliffordchance.com

By email and courier

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

Your ref:
Our ref: KMG
Direct Dial: +44 207006 2544
E-mail: kate.gibbons@cliffordchance.com

14 January 2013

Dear Sirs

FSB Consultative Documents on Strengthening Oversight and Regulation of Shadow Banking

We write in relation to the FSB Consultative Documents on Strengthening Oversight and Regulation of Shadow Banking, which were issued on 18 November 2012.

We have set out below our General Comments. Our responses to the three Consultative Documents are set out in Appendices 1-3.

General Comments

Our general comments reflect the issues that have arisen in implementing regulatory reforms since the financial crisis of 2007-8. Comparisons can be drawn between the approach that has been proposed by the FSB to strengthen the oversight and regulation of shadow banking and the approach taken in implementing other global regulatory reforms, in particular, the regulation of OTC derivatives. As these reforms are much closer to being implemented, it is important to reflect on lessons learned and factor these into the approach towards the regulation of shadow banking.

First we consider, more broadly, issues that have arisen recently in implementing other global regulatory reforms and then go on to comment generally on the proposals to regulate shadow banking activities.

1. Issues arising in cross-border regulation

(a) *The impact on the real economy*

Regulators are urged not to impose regulation before considering the impact on the real economy. Recent experience in relation to Basel III emphasises this: the Liquidity

CLIFFORD CHANCE LLP IS A LIMITED LIABILITY PARTNERSHIP REGISTERED IN ENGLAND AND WALES UNDER NO. OC323571. THE FIRM'S REGISTERED OFFICE AND PRINCIPAL PLACE OF BUSINESS IS AT 10 UPPER BANK STREET LONDON E14 5JJ. THE FIRM USES THE WORD "PARTNER" TO REFER TO A MEMBER OF CLIFFORD CHANCE LLP OR AN EMPLOYEE OR CONSULTANT WITH EQUIVALENT STANDING AND QUALIFICATIONS. THE FIRM IS AUTHORISED AND REGULATED BY THE SOLICITORS REGULATION AUTHORITY.

Coverage Ratio standards have required significant revision since it became clear that they would have a negative impact on collateral availability and adverse implications for important parts of the economy, notably trade finance.

(b) ***Alternative methods of achieving regulatory outcomes***

Consideration should be given to other ways by which regulatory objectives could be achieved e.g. whether increased reporting/monitoring, enhanced guidelines or best practices advocated by trade associations would be sufficient in some circumstances. The FSB is urged to emphasise to national authorities that regulating shadow banking should not be the *first* option: there should be a "rebuttable presumption" that regulation is not needed until it can be demonstrably shown, after a thorough cost-benefit analysis and impact assessment, that there is no other feasible way of mitigating systemic risk. We believe that the risk of national regulators resorting to regulation as a first option carries significant implications, particularly for the growth of the real economy, as the availability of alternative financing is often a "must have" to support areas of economic growth.

(c) ***Extra-territorial application***

Agreement should be reached at the outset on the extra-territorial reach of any proposed regulations. This would reduce the complexity and sheer volume of regulatory changes and bring clarity.

In the case of OTC derivatives reform, the absence of agreement between US and EU regulators on extra-territoriality has caused serious problems for the cross-border derivatives industry, prompting five Asian regulators to write to the CFTC on the issue. Extra-territorial issues were raised in 2010 but were not dealt with at the time and, in our view, neither the US nor EU proposals satisfactorily deal with the problem.

(d) ***Consistency of regulations***

Regulations intended to be global in effect should be consistent across borders. Regulators are urged to make a proper assessment and co-ordinate. If regulation is inconsistent – if there is no "level playing field" – there is a danger of regulatory arbitrage, with some activity moving offshore to jurisdictions which are perceived to have less stringent regulatory regimes.

(e) ***De-globalisation of regulation***

Regulators are urged to recognise the increasing trend for regulations to become "de-globalised" rather than to be global in nature as is envisaged by the G20 and FSB.

The implications of this are highly significant for the market e.g. firms may have to undergo structural changes or incur significant capital costs. This will cause a re-evaluation of business models and disruption to markets. Ironically, this will likely result in more shadow bank activity within national borders.

It will also impede the free flow of funds across financial markets leading to the 'Balkanisation' of pools of liquidity with negative implications for the financing of the global economy.

(f) *Implementation timetables*

A timetable for implementation should only be considered after a consensus has been reached on _what_ is going to be regulated and _how_.

In terms of timing, it is more important to agree the desired regulatory outcomes and agree the mechanisms as to how those outcomes are best achieved before fixing implementation dates. In some cases, having a long-term regulatory vision may be desirable and for this reason we agree with the FSB that "switching on the requirements" should be treated separately from agreeing policy.

There is also some merit in taking a "wait and see" approach to assess the impact of regulatory reforms that are already in the course of implementation, especially where they are likely to affect shadow banking e.g. AIFMD, Basel III/CRD IV, Solvency II, and UCITS reform.

Finally, the implementation of any policy proposals should be carefully considered and subject to prior, thorough cost-benefit analysis and impact assessments.

(g) *Conformity of legislative timetables*

Legislative timetables across jurisdictions should conform as much as possible. In particular, given the extent of work being done in Europe on shadow banking (and noting that the European Commission is planning to issue a Communication on shadow banking in Q1 2013, which will provide further details on legal proposals to be developed and the respective timing) there is a real possibility that the EU will seek to impose regulation on shadow banking ahead of the US and the rest of the G20. We think that the implementation of any EU regulatory proposals on shadow banking should coincide with those in other G20 countries, including the US.

2. Issues arising in relation to shadow banking proposals

Set out below are our general comments in relation to the proposals made by the FSB for improving oversight and regulation of shadow banking. See Appendices 1-3 for more detailed responses.

(a) *Improvements in monitoring*

Steps intended to improve monitoring in the shadow banking sector should continue. In principle, we agree with the need to improve monitoring as it is important for regulators to have accurate information in order to assess the level of risk that may be building up in the financial system, to identify which activities are most susceptible to systemic risk and hence make appropriate decisions on the direction of regulatory policy.

See Appendices for further comments in relation to monitoring.

(b) *Further clarity required on what is being monitored and regulated*

We think that progress has been made in clarifying what may be subject to increased oversight and regulation and that this should continue, as there are still significant areas where further clarity is needed.

We agree with the FSB that the focus should be on activities rather than on entities. However, given that the primary objective is to control systemic risk, regulators should focus only on those activities that can demonstrably be shown to be a source of systemic risk. We do not believe that all activities that are deemed to be "shadow banking activities" should *automatically* be regulated.

(c) *Further clarity required on how regulatory outcomes will be achieved*

There needs to be a convergence of opinion amongst regulators on *how* regulation will be implemented. This needs to be done at the outset to prevent problems occurring later on in the process and so that the implications of regulatory proposals are thoroughly considered and understood by both regulators and the market.

While some progress has been made, the regulatory tools proposed to achieve the policy objectives are not sufficiently detailed and in some instances, e.g. in relation to the regulation of "other shadow banking entities", they are described as a "menu of optional policies from which authorities can draw upon as they think fit". Further clarity is needed, as there will be significant implications for the real economy and exponential growth in regulatory arbitrage if national regulators choose different approaches to how the regulatory objective is to be achieved, even if they share the desired outcome.

What the markets will need most is a good degree of certainty. Until then, it is virtually impossible for businesses to make the decisions needed to move forward. In turn, this hampers growth in a very real way.

We hope our comments are useful. Please do not hesitate to contact us if you wish to discuss further.

Yours faithfully

Clifford Chance LLP

Appendix 1

An Integrated Overview of Policy Recommendations

Set out below are our comments on the issues raised in the FSB Consultative Document "*Strengthening Oversight and Regulation of Shadow Banking – An Integrated Overview of Policy Recommendations*".

1. Balancing risk against growth

Formulating the regulation of shadow banks in such a way that balances reducing systemic risk in the financial sector against preserving the benefits of shadow banking – providing liquidity, innovation, competition, lower borrowing costs and specialised expertise in certain niche areas – is of fundamental importance.

The beneficial aspects of shadow banking are recognised by the FSB, but there should be a lot more emphasis on assessing the implications on the real economy.

2. Scoping and defining "shadow banking risks"

One of the most fundamental issues in the debate about the regulation of shadow banking is what exactly is meant by the term "shadow banking". One preliminary issue to be addressed, therefore, is whether we are any clearer on what regulators are likely to perceive as shadow banking risks.

The broad description of shadow banking put forward by the FSB in October 2011 i.e. "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" is, in our view, a good starting point but imprecise and lacking in clarity. This, together with an insufficient understanding of the intricacies of the shadow banking system and its complex interaction with the banking system, means that there is a danger of inappropriate regulations being imposed, leading to unforeseen and unintended adverse consequences.

Adopting a practical solution to this problem, the FSB has focused on the following areas and activities undertaken by "*non-bank financial entities*" where risk to financial stability (shadow banking risks) may arise:

- Where non-banks interact with banks;
- MMFs;
- Five economic activities undertaken by non-bank financial entities other than MMFs (other shadow banking entities) where risks to financial stability arise because they are involved in credit intermediation that involves maturity/liquidity transformation, leverage, and/or credit risk transfer;
- Securitisation; and
- Aspects of securities lending and repurchase transactions.

In our view, progress has been made in providing further clarity on areas/activities that are perceived to be sources of "shadow banking risk" i.e. what regulatory authorities should monitor. In general, we agree that the focus should be on activities rather than entities (although the distinction is blurred in places e.g. in WS3, see below). However, given that the primary objective is to control systemic risk, regulators should focus only on those activities that can be demonstrably shown to be a significant source of real systemic risk. We do not believe that all activities deemed to be "shadow banking activities" should be regulated, or regulated any more than at present.

Regulators are urged to avoid categorising techniques and activities as economic functions. This is especially the case in the context of securitisation, which is really "a term of art". As a broad set of various skills and techniques, rather than an economic function, attempts to regulate securitisation have always resulted in difficulties when regulators seek to apply a "one-size-fits-all" approach.

3. Data collection and monitoring

As stated above, we agree with the need for enhanced monitoring and transparency in the shadow banking system as it is important for authorities and the markets to understand how the shadow banking system works and how it interrelates with the regular banking system. However, since there will be considerable costs involved in providing the information, regulators should carefully assess what information is required and whether it can be provided from existing sources. They will also need to ensure that they have the necessary expertise and resources for reviewing the data they have received. As the monitoring will take place on a global basis, agreement between authorities on what should be reported and how is vital.

We think that while there have been improvements in monitoring since the first Global Monitoring Report was issued in 2011, further improvements could be made. In terms of obtaining more granular data via trade reporting, however, we would reiterate the points made above regarding the likely cost and suggest a thorough cost-benefit analysis be undertaken before imposing new reporting requirements, including the establishment of de minimis levels.

Finally, we note that "monitoring", in the context of shadow banking, relates to the work conducted by the FSB in connection with its Global Shadow Banking Monitoring Report and to policy recommendations for increased transparency and reporting proposed by some of the FSB Workstreams, e.g. WS5 on securities lending and repos. However, we do not think that it is sufficiently clear at the moment how these interrelate.

4. Proposed policy recommendations

As a general point, we agree that the authorities' approach to shadow banking has to be targeted and that the objective is to ensure that shadow banking is subject to "appropriate oversight and regulation to address bank-like risks to financial stability ... while not inhibiting sustainable non-bank financing that do not pose such risks".

While we agree that the recommendations proposed by the FSB do present the G20 with proposals that may, _depending on how they are implemented_, reduce systemic risk in the shadow banking sector, given that so much will depend on _which_ policy recommendations are implemented and _how_, it is not certain at this stage whether the important objective referred to by the FSB, i.e. reducing risk in the financial sector while not inhibiting sustainable non-bank funding, is likely to be achieved. Importantly, it cannot be said with certainty that the implications of the policy proposals have been fully understood and that therefore the risk of adverse consequences arising has been mitigated.

WS1 Banks' Interaction with Shadow Banks

We note that the BCBS is continuing its review of banks' interaction with shadow banks. This is probably the key issue in reducing systemic risk.

In addition, we note that the focus has been on three key areas on which the BCBS will report in mid 2013: scope of consolidation; large exposures; and banks' investment in funds, with the FSB asking the BCBS to ensure that banks' support to MMFs and other sponsored vehicles is adequately captured by its work on the scope of consolidation and/or its treatment of reputational risk and implicit support.

In relation to banks' investment in some funds, the current regime, e.g. in relation to deductions, is very complicated and can lead to some "odd" results. Care must be taken not to make matters worse.

With regard to "banks' support" or "implicit support" of funds, we think this should not be open-ended, so that any sort of association with funds has some sort of negative consequence, most likely increased costs.

We note that the BCBS is continuing its existing work to aid the full implementation of its July 2009 guidance on the treatment of reputational risk and implicit support under Pillar 2 and that, in relation to capital requirements relating to banks' short-term liquidity facilities to shadow banking entities that are outside the scope of the Basel III securitisation framework (e.g. MMFs), it has decided not to make further policy changes that could potentially have an adverse effect "and may be unnecessary in light of other changes, such as the introduction of the liquidity coverage ratio (LCR)".

For the reasons given above in our General Comments, we think this is a sensible approach and that it would be better to "wait and see" the outcome of these before proposing further changes.

WS2 MMFs

As a general point, it should be recognised that MMFs are already largely regulated. It would be preferable to work within existing regulatory frameworks rather than impose new regulations.

It is also important to recognise that there were very few MMFs that actually "broke the buck" and the reason why they did arose as much from the unintended consequences from other "causes" (such as short selling bans) as it did from the distress of the underlying assets. Understanding all the causal effects is, therefore, important.

In general, we agree with the IOSCO recommendations, subject to the following comments:

- Consideration should be given to "near" MMFs – those funds that are very similar to MMFs, but which for one reason or other just fall outside the definition.

- Focus should be, as it is, on constant NAV MMFs (for variable NAV MMFs, all the same considerations apply as with any other fund).

- We should not impose liquidity buffers or bank-like capital requirements. While managers need to ensure they have sufficient liquidity to meet redemption requests, this should be tested in line with the ability to impose tools such as redemption gates, suspension of redemptions, redemption fees, and redemption notice periods.

- Disclosure to investors – we agree that there should be requirements regarding disclosure to investors. However, it is important to differentiate funds offered to retail investors from those offered to sophisticated investors. In our view, proper disclosure to investors is a key part of this debate as in some instances it removes the need for regulation i.e. disclosure to sophisticated investors, who can properly price risk may be an adequate solution and regulation intended to protect retail investors may not be appropriate.

WS3 Other Shadow Banking Entities

Please see our response in Appendix 2.

WS4 Securitisation

Attempts to regulate securitisation have always resulted in difficulties when regulators seek to apply a "one-size-fits-all" approach. In reality, there are numerous products and vehicles which employ securitisation-style features, which each carry different risks. Any regulation which seeks to limit these products and vehicles needs to be carefully targeted otherwise it may capture products and services that use similar securitisation-style techniques but which do not carry the same risk. For this reason we would suggest that economic functions that result in shadow banking risks are specifically identified rather than broadly describing "securitisation" itself as something which has shadow banking risks. The analysis of the activities involved in securitisation needs to be more granular.

Care should also be taken to ensure that any recommendations made in WS3 in relation to economic functions which may be relevant to securitisation products and vehicles reflect and consider the substantial work already undertaken in respect of WS4. Currently it is not clear how these interrelate.

WS5 Repos and Securities Lending

Please see our response in Appendix 3.

Appendix 2

A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

Our comments with respect to the questions raised in the FSB Consultative Document "*A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*" are set out below.

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?

Given that the policy framework for strengthening the oversight and regulation of shadow banking entities is "high-level", it is difficult to say with certainty that it *effectively* addresses shadow banking risks. For example, as one of the elements of the policy framework is "a menu of optional policies from which authorities can draw upon as they think best", it is not certain, at this stage, exactly which policy tools will be chosen by an individual regulator and whether they are likely to be effective.

Likewise, the policy framework addresses the risk of regulatory arbitrage, but in the absence of specific regulatory proposals, it is premature to say that this risk has been minimised.

In summary, although the policy framework marks an important step forward in providing more detail on how national regulators should *approach* the regulation of shadow banking entities, clarity is required on *how* the policies will be implemented, *who* will be affected by them and *what* the impact of any new regulation will be.

In addition, given the complexity of the shadow banking sector and the degree of interconnectedness with the banking sector, a thorough impact assessment should be undertaken. This should also take into account the impact of reforms that are already under way. Many of the shadow banking concerns raised in the FSB papers are or will be adequately addressed by these measures. It would be preferable to "wait and see" what their impact has been before imposing further regulation on the financial sector.

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).

WS3 sets out five economic functions that *may* give rise to shadow banking risks:

- management of client cash pools with features that make them susceptible to runs;

- loan provision that is dependent on short-term funding;
- intermediation of market activities that is dependent on short-term funding or on secured funding of client assets;
- facilitation of credit creation; and
- securitisation and funding of financial entities.

It cannot be said with certainty that these capture <u>*all*</u> non-bank financial activities that may pose shadow banking risks. They do, however, provide a practical starting point of activities that could be subject to closer scrutiny. As stated above, the existence of a particular activity does not automatically mean that it poses systemic risk and should be regulated.

In addition, we have the following specific comments:

- *Entities versus Activities*

  We agree that the focus should be on activities rather than entities, although it is noted that the activities will be mapped to entities later on in the process by national regulators.

  We also think that consideration should be given to de-minimis levels in the context of activities (see response to question 4 below).

- *Securitisation*

  As mentioned in Appendix 1, care should be taken in broadly labelling securitisation as an "economic function" when it is, in fact, a set of skills and techniques that may have a variety of effects. To the extent there are any functions performed by securitisation products and vehicles which are not already categorised, these should be individually investigated and care should be taken to ensure there is no inconsistency with the work already undertaken in WS4.

  There is discussion in parts of the Consultative Documents that identifies maturity and liquidity transformation as a function of securitisation that creates shadow bank-style risks. In the vast majority of securitisation products and services there is no maturity or liquidity mismatch – the securitised assets are self-liquidating and the repayment of the investment is dependent on those assets producing cash. In cases where there is a mismatch (e.g. ABCP conduit funding longer-term assets), the mismatch is mitigated by bank liquidity facilities, and therefore already falls within the regulatory perimeter.

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 have no specific comments on this question.

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?

We agree that the policy tools put forward by WS3 may mitigate systemic risk for a particular economic function. However, there are some significant drawbacks to some of the policy tools which will need further analysis to weigh up the relative advantages and disadvantages of each tool.

We also think that it would be helpful to prioritise the tools or code them in some way relative to their respective advantages and disadvantages.

Enhanced disclosure and monitoring of risk should be the first step, with policy tools only employed for those activities deemed as presenting an unacceptable level of risk to financial stability. This is especially the case for those activities that are either less risky or which have little systemic impact. As stated above, the presumption should be that regulation is not needed, such presumption to be rebutted only if it can be demonstrably shown that other non-regulatory tools and existing regulations are not adequately mitigating the risks.

Thought should be given to the feasibility of the policy tools e.g. imposing a requirement to have liquidity buffers is mentioned as a possible policy tool in several of the economic areas. Will there be sufficient good quality assets available given the increased demand for collateral? Will imposing the tools stymie shadow banking entities i.e. will liquidity buffers and leverage limits prevent these entities from realising their investment objectives?

Further guidance needs to be issued to national regulators on how to assess the implementation of the tools i.e. to elaborate on the statement: "regulators should regularly assess the effectiveness of their regulatory measures after implementation and make adjustments to improve it if necessary".

Finally, it is not clear when policy tools would be used. Will there be a threshold trigger or de-minimis requirements for entities engaging in one or more of the economic functions that have been identified as creating shadow banking risks? For instance, will entity A (whose business is entirely composed of one or more of the five economic functions) be subject to the same degree of regulation and supervision as entity B whose business is only partially composed of a relevant economic function? Similarly, will there be differences of approach for entities which do and do not take deposits and which do and do not alter maturities?

We have the following specific points on the proposed policy tools.

Mitigating the risks arising from management of client cash pools with features that make them susceptible to runs

- As a general point, many of the policy tools, if implemented, would result in many of the funds (being the type of entities most likely to be affected by the regulatory focus on this economic activity) becoming very similar. This would have the negative consequence of reducing investor choice and flexibility. However, one key aspect should be on appropriate disclosure to investors, so that they can understand the objectives and terms of the funds they are investing in and can invest on an informed basis.

- In addition, many of the policy tools, in particular side pockets, redemption gates, suspension of redemptions and redemptions fees are used (often in the alternative) to mitigate risks already and we do not believe that their use should be a mandatory requirement. Furthermore, there is a danger that some tools would be inappropriate e.g. gates are not needed if the assets are highly liquid.

- *Tool 1: Restrictions on the maturity of portfolio assets*

  Tools such as restrictions on the maturity of assets, may result in funds becoming homogeneous and less diverse. This may distort the market and will reduce investor choice and the level of returns. The size of the fund may be important as some might not necessarily be able to obtain assets of the required maturity. In addition, if it is known in the market that funds may only invest in assets of a certain maturity, there is a risk of "front running" i.e. of assets of the required maturity being purchased by another investor, and the fund having to purchase them at a higher price.

- *Tool 2: Limits on leverage*

  The level of leverage, as well as information on what fund assets are subject to a security interest, are typically disclosed in offering documents, so fund investors (for the most part, institutional investors) can make an informed decision on whether to invest. This can be distinguished from bank deposits, where depositors are, for example, probably unaware of the level of bank leverage.

- *Tool 3c: Liquidity buffers*

  We do not think that liquidity buffers are an appropriate policy tool as they will adversely weigh against the performance of the fund.

- *Tool 4a: Side pockets*

  We do not think that regulators should impose a regulatory requirement to use side pockets. Also, further clarity should be provided. There are two types of side pockets: those imposed at the outset and those imposed in times of stress.

Imposing the latter type of side pocket to address stressed situations may trigger a run, but that situation should be clearly distinguished from side pockets that are in place from the outset of a fund to hold illiquid assets and which are disclosed to investors.

- *Tool 4b: Redemption gates*

  Raising a redemption gate might trigger a run (but, importantly, this allows the fund to permit a managed exit).

- *Tool 4c: Suspension of redemptions*

  In addition to the tool of suspending redemptions, it is also possible to have a suspension of the payment of redemption proceeds after a redemption has been accepted. However, if an investor does redeem, agrees the NAV, but is not paid out immediately, there is a risk of exposure if the value of the investment falls in the period between the NAV valuation date and the payment date.

- *Tool 4d: Imposition of redemption fees*

  In considering redemption fees, it needs to be determined who gets the fee – the fund or the fund manager.

  Consideration can also be given to minimum notice periods for redemptions: 30 days gives a longer period to divest assets than, for example, one day.

Loan provision that is dependent on short-term funding

- As a general point, it is significant that loan provision which is dependent on short-term funding has been identified as one of the economic activities undertaken by non-bank financial entities where shadow banking risks arise and to which policy tools may apply. The policy tools that have been suggested are similar to those applied to banks in order to protect depositors, although we assume they would have to be calibrated differently. Determining what is to be achieved by applying a tool designed to protect deposits to institutions where deposit protection is not a principal concern is important, since this could have significant impact on credit funds, CLOs and other types of loan market investor at precisely the time when the market is looking to them to fill the funding gap left by banks. Much will depend on what is meant by "short-term funding". Further clarity is required as is a thorough analysis of the impact of imposing the policy tools.

- *Tool 7: Maturity mismatch*

  How frequently will apparent mismatches be looked at and how will "unreasonable" mismatches be singled out from other "reasonable" or managed mismatches?

Securitisation and funding of financial entities

- *Tool 1: Restrictions on maturity/liquidity transformation*

  We agree with the general approach that any restrictions would have to be tailored to the relevant securitisation structure. Additionally, whether or not any such restrictions are introduced should be proportionate to the risks entailed with the relevant transaction – as we note above, the majority of securitisation products and vehicles do not involve maturity or liquidity transformation.

- *Tool 2: Restrictions on eligible collateral*

  Collateral haircuts and other risk management policies are already commonly used by liquidity sellers. Any additional restrictions may risk constraining the liquidity of the ABS market in circumstances where the FSB is keen to ensure their revival.

- *Tool 3: Restrictions on exposures to, or funding from, banks/other financial entities*

  In seeking to reduce the opportunities of arbitrage, care needs to be taken not to limit funding opportunities in a financial sector that is undergoing a significant deleveraging. To the extent any such exposures relate to banks, they are already within the regulatory perimeter, due to the application of existing bank regulation such as large exposures.

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.

An important consequence of imposing at least some of the regulatory tools will be a reduction in liquidity. As banks have reduced their lending, shadow banks have stepped into the breach. This will reduce if some of the policy tools are introduced. This will have a negative impact on growth.

It is inevitable that firms will face increased costs in implementing the high-level policy framework. These would include costs associated with conducting activities should certain policy tools be implemented e.g. capital charges, as well as compliance and operational costs (e.g. in providing the data required by regulators). This will undoubtedly increase the cost of borrowing. A thorough cost-benefit analysis and impact study should be conducted prior to implementation of the policy framework.

Appendix 3

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

Our comments with respect to the questions raised in the FSB Consultative Document "*A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*" are set out below.

General questions

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.

Yes.

However, we would make the point that not all financial stability risks in the securities lending and repo markets are necessarily systemic. The risks arising should be assessed by the authorities and careful consideration given to how these risks can be managed or mitigated. Given the ramifications of imposing the policy tools that have been proposed, the regulatory response should be considered and proportionate.

We do not think that there are any additional financial stability risks in the securities lending and repo markets that should be addressed.

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 our view, the policy recommendations that have been proposed are comprehensive and have the potential to address the financial stability risks that have been identified. However, as at this stage it is not certain *which* of the recommendations will be implemented by national regulators and *how*, it is premature to conclude that financial stability risks have been adequately – or effectively – addressed.

We would also reiterate that, as the implications for the securities lending and repo markets and the wider financial markets are significant, a thorough cost-benefit analysis and impact assessment should be conducted prior to any new regulation being implemented. It would also be better to assess the impact of the regulatory developments that are in the course of implementation, e.g. recent developments in

the EU on the use of repos and securities lending by ETFs and UCITS, before proposing any further regulation.

Q3. Please explain the feasibility of implementing the policy recommendations (or any alternative that you believe would more adequately address any identified financial stability risks) in the jurisdiction(s) on which you would like to comment?

Subject to the comments we have made elsewhere, we think it is feasible to improve disclosure/reporting requirements. However, we are less convinced on the feasibility of establishing a trade repository for repo and securities lending transactions due to the cost involved and suggest that any moves to establish one be postponed until a detailed impact assessment has been undertaken.

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 there would be considerable cost to the repo and securities lending industry and the wider financial markets were the policy recommendations to be implemented (e.g. increased operational costs involved in reporting or clearing trades).We would hope, therefore, that regulatory measures are only introduced after a thorough cost-benefit analysis and impact assessment has been carried out.

There are a number of significant consequences of implementing the policy recommendation, which should not be underestimated.

- *Adverse impact on funding*

  Repos are a key source of funds for some shadow banking entities. They are also a key source of funds for entities that are not shadow banks and are an essential part of the traditional banking sector. The beneficial role repos play in the money markets should not be underestimated. The demand for funding is unlikely to diminish and if repo financing is restricted or made more expensive it is difficult to see where the funding requirements will be met in the current economic climate.

- *Collateral shortages*

  There is increasing use of collateral as a risk mitigant – to comply with liquidity ratios, for centrally cleared derivatives and OTC derivatives. This has led to an ever-increasing demand for good quality collateral. Imposing regulation on repo and securities lending markets may reduce the pool of eligible collateral.

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)?

We are not in a position to suggest an appropriate phase-in period as much will depend on exactly which policy recommendation is implemented and some (e.g. trade reporting to a trade repository) will take longer to implement than others.

As a general point, however, we agree with the FSB that it is important to suggest policy proposals for long-term application and treat the implementation of these requirements separately, after the necessary cost-benefit analyses and impact studies have been concluded and at a point when the impact of reforms that are already in progress but not fully implemented (e.g. Basel III) have been assessed.

Assuming that any proposed regulation will be subject to a "phase-in" period, consideration should be given to how this is implemented so that no extra-territorial issues arise, as they have, for example, in the context of OTC derivatives.

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.

As a general point, we agree that there is a need for appropriate transparency on a global basis and this is true in relation to repo and securities lending (as with other sectors) so as to enable regulators to identify sources of systemic risk in this sector. However, before mandating reporting requirements, a proper analysis should be made of what information is needed and whether it can be obtained from existing sources. We believe that industry best practices also have a role to play in the furtherance of increased disclosure and transparency.

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?

We think that trade reporting requirements should be carefully considered, given the largely short-term nature of the repo markets and the cost of such reporting. A thorough analysis of exactly what data is needed, and for what purpose, should be conducted before any reporting requirements are introduced, especially reporting to a trade repository.

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?

There will be a number of significant issues to consider, primarily whether establishing a trade repository is needed at all if the information that can be obtained by regulators via other means is satisfactory. If it is determined that trade repositories should be established, lessons should be learned from the OTC derivatives market. For example:

- The proposals for establishing a trade repository for repo and securities lending should be consistent with the requirements in the OTC derivatives market to the extent that this is feasible – is it possible for the same trade repositories to be used so that reporting institutions can benefit from economies of scale?
- The requirements for reporting to a trade repository should be consistent internationally; and
- Confidentiality issues should be resolved at the outset.

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 agree that there should be enhanced disclosure to regulation, although further analysis needs to be undertaken to determine exactly what regulators need and what the market can realistically provide, using existing reporting mechanisms as much as possible.

We do not necessarily believe that enhanced disclosure should be made public: the information may be price sensitive and confidential.

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.

In relation to the proposed requirement for authorities to review the reporting requirements for fund managers to end investors, we think more transparency would be useful for investors in regulated funds. However, we note that measures have already been taken to improve transparency for regulated funds in the US and in the EU. These should be taken into account before imposing any new regulatory requirements.

We do not think this would be useful in the context of private funds as there is a danger of "information overload". Also, it would not be desirable for a fund's short positions to be known by the market – other investors would "bet against you".

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?

We have no specific comments on this question.

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?

We have no specific comments on this question.

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 have no specific comments on this question.

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

We have no specific comments on this question

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?

We have no specific comments on this question.

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?

We have no specific comments on this question.

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.

We have no specific comments on this question.

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?

We have no specific comments on this question.

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 have no specific comments on this question.

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

We note that the FSB has defined "re-hypothecation" as the reuse of client assets. As the collateral in repo and securities lending transactions is transferred by way of full title transfer it will not fall within the definition of re-hypothecation.

We agree that there should be sufficient disclosure to clients so that they can understand their exposures in the event of failure of an intermediary. Further clarity should be provided on what disclosure would entail.

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 principle, we agree with proposed minimum standards for the valuation and management of collateral by securities lending and repo market participants. However, we think that further clarification on this would be helpful.

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) *Central Clearing*

Recommendation 12 states that "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".

Beyond the inter-dealer repo market (where there are considerable incentives for central clearing e.g. balance sheet netting and lower capital requirements) we do not think that the advantages of central clearing will outweigh the disadvantages that have already been noted by WS5. In any event, repo and securities lending transactions are

self-collateralising: if initial and variation margin have been properly delivered, the trade does not need to be centrally cleared. We think the focus should be on robust collateral management rather than on a shift to central clearing.

(b) ***Changes to bankruptcy law treatment of repo and securities lending transactions***

We do not agree that there should be changes to the bankruptcy law treatment of repo and securities lending transactions.

Any such changes would be a negative step, not least because of the considerable legal uncertainty thereby arising in the markets and as between parties to a repo, which could itself lead to systemic risk.

For these reasons, we agree with WS5 that any changes to the bankruptcy treatment of repos and securities lending transactions will involve substantial practical difficulties and that, therefore, this should not be prioritised for further work at this stage.