

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

## Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions

(for public consultation)

(FSB : August - November 28,2013)

Amundi appreciates very much the opportunity to express views in the framework of the public consultation initiated by the Financial Stability Board (FSB) on minimum haircuts applying to non-centrally cleared Repo and securities lending activities. Amundi is convinced that systemic risk may arise from high leverage or maturity transformation and credit concentration resulting from securities lending and Repos. It welcomes FSB initiative to mitigate these risks and enhance financial stability worldwide. However, it is also very conscious that regulation should not overshoot its goals and hit activities with low risk and/or largely regulated and supervised. Proportionality is the prime principle.

With more than 750 billion € under management at the end of September 2013, Amundi is one of the leading fund managers in the world, ranking second in Europe and first in France. It serves in many different countries many different types of clientele to which it offers investment solutions in a large diversity of investment strategies. Investment funds (funds) do use efficient portfolio management (EPM) techniques such as securities lending and repo to improve their return and adjust their liquidity.

Before answering to the questions where we feel we have an experience that might bring an interesting contribution to the debate, we would like to produce the following general comments on FSB's approach:

- Fund industry is very strictly regulated and tightly supervised in Europe with for example the *UCITS directive* and ESMA's *guidelines on ETFs and other UCITS issues* published in December 2012 that directly impact collateral management of UCITS as well as the new AIFM framework and the role of national regulators as AMF in France; **European funds should definitely be considered less risky than prudentially regulated entities** knowing that the maximum leverage of a UCITS is 2 and that when it exceeds 3 for some AIFs it is under close scrutiny;
- **Direct regulation of leverage is more efficient** than introduction of minimum haircut requirements in order to reduce systemic risk; it should be conducted

at an **international level** in order to avoid competitive distortions on a worldwide market;

- **Information collection** and data analysis should be implemented first and without delay as suggested by FSB's first 5 principles on transparency; it should rely as much as possible on **existing reporting** to TR, CCPs or regulators to avoid imposing a new burden on buy-side actors such as asset managers;
- **Securities law** is the point where attention should focus before analyzing the chain of ownership of securities and assessing ways to secure it; securities law in continental Europe presents definite advantages in terms of safety (and Amundi is ready to expand on this topic if needed); as well as **bankruptcy law** it is difficult an issue, but it is not a reason not to address it; in that respect principle 11 as expressed by FSB is disappointing as high level of efforts should not prevent high implication to solve highly important issues.

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Amundi submits the following answers to the public consultation.

***Q1. Do the proposed policy recommendations in Annex 2 adequately limit the build-up of excessive leverage and reduce procyclicality? Are there alternative approaches to risk mitigation that the FSB should consider to address such risks in the securities financing markets? If so, please describe such approaches and explain how they address the risks. Are they likely to be adequate under situations of extreme financial stress?***

FSB recommends to limit excessive leverage and reduce procyclicality by regulating securities financing markets. Asset managers do not use securities lending or repo markets for financing purpose and an ideal regulation should deal with excess use of these markets only. In that respect a direct regulation on builders of leverage would be more efficient.

***Q2. What issues do you see affecting the effective implementation of the policy recommendations?***

Amundi has two main concerns. On one hand any regulation should be implemented on an international basis at the same time to avoid transfers and regulatory arbitrages. On the other hand, introducing different levels of requirements for different types of actors would lead to a split market and lower the overall liquidity of the market. Asset managers cannot be treated differently from prudentially regulated entities.

***Q3. Please address any costs and benefits, as well as potential material unintended consequences arising from implementation of the policy recommendations? Please provide quantitative answers, to the extent possible that would assist the FSB in carrying out a quantitative impact assessment. [Note: respondents may also consider participating in QIS2]***

Analysis of collected data will help FSB to make a detailed assessment of unexpected impacts. It is very important to proceed in two steps: data collection and analysis first and adapted regulation afterwards.

***Q4. What is the appropriate phase-in period to implement the policy recommendations? Please explain for (i) minimum standards for methodologies and (ii) the proposed framework for numerical haircut floors separately.***

Amundi has already written a policy on collateral and haircuts and developed internal tools to monitor collateral. However not all asset managers have and some may have to implement new systems where we could expect to adapt marginally. Question is to know whether we are to face only marginal adjustments that can be realized in a matter of months or prepare for a large project that will, due to budget procedures, require 2 years.

***Q5. Are the minimum standards described in Section 2 appropriate to capture all important factors 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?***

FSB's presentation is globally satisfactory. In practice, Amundi has a policy for collateral and haircut -which is required by ESMA's guidelines for UCITS. We feel that the key parameters are high credit quality and liquidity of collateral; these are however not easy to express in statistical analysis and mathematical models.

In general terms, collateral is only a second-level risk : the first level is the quality of the counterparty and collateral comes into play to cover and mitigate that risk. Mitigating this second level of risk through minimum haircuts is a third- level consideration and should be carefully balanced with the level of administrative work it would impose on actors for a limited reduction of risk.

Furthermore, Amundi considers that the proper approach in terms of collateral is to authorize as collateral a large diversity of eligible assets, provided that there is an appropriate haircut policy.

***Q6. Would the additional considerations described in Section 3 appropriately capture all important factors that should be taken into account in setting risk-based haircuts on a portfolio basis? Are there any other important considerations that should be included? How are the above considerations aligned with current market practices?***

The proposed recommendation sounds familiar when put in comparison with controls conducted on UCITS in compliance with ESMA's guidelines: diversification, stress testing, liquidity and credit quality, wrong way risk...are all part of the existing set of rules already in place. Our experience however is that these rules should not lead to a lower safety for fund holders. For example, for the sake of diversification ESMA requires that credit risk on collateral be limited to 20% per issuer which is

counterproductive for a fund that wants to have high quality German government bonds as only collateral. FSB should be aware of that type of side effects.

Once again, haircut should be determined according to credit quality and liquidity of the collateral and accordingly we suggest that bonds and notes issued by SIFIs, subject to a tight supervision and an enhanced prudential regulation, should be exempt from haircut and eligible on the basis of their value.

The suggestion to give BCBS a mandate to control the appropriateness and the efficiency of collateral regulation as developed by national or regional competent authorities is probably a little bit far reaching in terms of dedicated competences. It should be considered as an example that might prove impossible to implement.

***Q7. In your view, is there a practical need for further clarification with regard to the definition of proposed scope of application for numerical haircut floors?***

We consider that there is an inappropriate shortcut in the definition of the proposed scope. Funds do not participate in securities financing transactions as they are final investors, but use Repos and securities lending (as lenders essentially) with a view to improve return for their holders. Hence, asset managers consider they should be clearly out of the scope as intended by the regulators and that a clarification is necessary to exempt them. Furthermore, their own regulations are more demanding than those of banks in terms of leverage or concentration.

***Q8. Would the proposed scope of application for numerical haircut floors be effective in limiting the build-up of excessive leverage outside the banking system and reducing procyclicality of that leverage, while preserving liquid and well-functioning markets? Should the scope of application be expanded (for example, to include securities financing transactions backed by government securities), and if so why?***

With reference to government securities, we agree with FSB to leave them out of the scope of the proposed regulation. As mentioned, we think that securities issued by SIFIs could as well be exempted from minimum haircut requirement. However, we consider that the internal collateral and haircut policy of a counterparty should differentiate according to the credit quality of these issuers, governments or SIFIs.

***Q9. In your view, what would be the impact of introducing the numerical haircut floors only on securities financing transaction where regulated intermediaries extend credit to other entities? Does this create regulatory arbitrage opportunities? If so, please explain the possible regulatory arbitrage that may be created and their impact on market practices and activity.***

If active counterparties were to have different regulatory requirements, one should fear a divided market and a sudden drop in liquidity. Funds should benefit from the same exemption as prudentially regulated entities.

If banks as regulated entities were out of scope and funds were not, can we assess that funds with a guarantee by a bank of the initial capital are exempted? How if the guarantee is limited to 90% of the initial capital?

***Q10. In your view, would the proposed levels of numerical haircut floors as set out in table 1 be effective in reducing procyclicality and in limiting the build-up of excessive leverage, while preserving liquid and well-functioning markets? If not, please explain the levels of numerical haircut floors that you think are more appropriate and the underlying reasons.***

The figures as exposed in table 1 are satisfactory as minimum haircut requirements : they look significant and not unrealistic. In many instances internal rules at Amundi lead to higher levels of haircut, but due to a more detailed set of criteria there are instances where the proposed schedule will lead to a higher requirement. We feel that asset managers should be granted freedom to determine the haircut levels they prefer and should not be considered differently from prudentially regulated entities.

Specifically, we are concerned that cash collateral not denominated in the valuation currency of the fund might be subject to the 7.5% minimum haircut, when it is totally liquid. We suggest that this case be addressed separately.

***Q11. Are there additional factors that should be considered in setting numerical haircut floors as set out in table 1? For example, should “investment grade” or other credit quality features be factored in?***

Different factors are included in asset managers own policies, but the minimum haircut requirement should be simple in its approach and not refer to any other criterion.

***Q12. Are there any practical difficulties in applying the numerical haircut floors at the portfolio level as described above? If so, please explain and suggest alternative approaches for applying the numerical haircut floors to portfolio-based haircut practices?***

The notion of portfolio has to be clarified. In our view the portfolio should be the sub-fund or compartment level of a fund.

***Q13. What are your views on the merits and impacts of exempting cash-collateralised securities lending transactions from the proposed framework of numerical haircut floors if the lender of the securities reinvests the cash collateral into a separate reinvestment fund and/or account subject to regulations (or regulatory guidance) meeting the minimum standards? Do you see any practical difficulties in implementing this exemption? If so, what alternative approach to implementing the proposed exemption would you suggest?***

Amundi agrees with FSB’s analysis that securities lenders are not motivated by a purpose of refinancing but want to take advantage of an extra revenue for the loan of their securities. The cash they receive is a protection against counterparty’s default.

Reinvestment restrictions are necessary in that view. However the key point is to control that reinvestment is properly done.

“Special” repo where the receiver of cash receives more than the value of the repoed securities should be aligned with securities lending: it is not a financing technique. A fund may use one EPM technique or the other alternatively.

***Q14. Do you think cash-collateralised securities borrowing transactions where the cash is used by the securities lender to meet margin requirements at a CCP should also be exempted from the proposed framework of numerical haircut floors?***

Yes, it is of practical interest for funds which need cash to meet CCPs margin requirements. If, and it is a reasonable assumption more than a question, CCPs are safe enough to be trusted and are limited in the way they may reinvest cash, the general system will be secure.

***Q15. What are your views on the proposed treatment of collateral upgrade transactions described above? Please explain an alternative approach you think is more effective if any.***

The proposed rule against circumvention of the framework is simply unavoidable.

***Q16. What are your views on exempting collateral upgrade transactions from the proposed framework of numerical haircut floors if securities lenders are unable to re-use collateral securities received against securities lending and therefore do not obtain financing against that collateral?***

Amundi shares the view that a transaction leading to no leverage should not be subject to minimum haircut requirement.

***Q17. What do you view as the main potential benefits, the likely impact on market activities, and possible material unintended consequences on the liquidity and functioning of markets of introducing the proposed framework of numerical haircut floors on securities financing transactions as described above?***

The proposed approach of FSB respects the idea that collecting data is the first need and that implementation of leverage limiting devices will come afterwards. The link with OTC derivatives is relevant and coordination is necessary. A consistent approach relying on sound data analysis and implemented globally is what we consider as a sound regulatory process.

***Q18. Would implementing the proposed numerical haircut floors through regulatory capital or minimum margin regimes for regulated intermediaries be effective in reducing procyclicality and in limiting the build-up of excessive leverage by entities not subject to capital or liquidity regulation?***

Indirect regulation is less efficient than direct limitation on leverage of other entities. As funds are severely regulated in terms of risk exposure and leverage (UCITS may

not have more than 200% risk exposure and AIF are subject to specific reporting if their leverage is higher than 3) they should not be considered as “other entities”.

**Q19. Are there specific transactions or instruments for which the application of the proposed framework of numerical haircut floors may cause practical difficulties? If so, please explain such transactions and suggest possible ways to overcome such difficulties.**

What is not clarified in the proposed framework is the definition of a “securities financing transaction”. If the motive of the transaction is financing, then the minimum haircut requirement or any other means to limit leverage should apply. But the same transaction can be motivated by other reasons and should benefit from an exemption. See Q 13 on special Repo.

**Q20. What would be an appropriate phase-in period for implementing the proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions? Please explain for (i) minimum qualitative standards for methodologies and for (ii) numerical haircut floors separately.**

Impact assessment will require some time after collection of data.

For numerical haircut floors, actors will need operational delays and a global implementation will reflect the delay needed by the less reactive party. Say a couple of years.

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