Frankfurt am Main,
28 November 2013

BVI`s response to the FSB Consultative Annex for a Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions

BVI[1] gladly takes the opportunity to submit its comments on the policy recommendations on minimum haircuts for non-centrally cleared securities financing transactions.

We support in general a regulatory framework for haircuts on non-centrally cleared securities financing transactions. The German investment funds industry is subject to long-established provisions regarding securities lending and repo transactions. We will focus our response on possible benefits and drawbacks of the proposed approach to regulated investment funds (e.g. UCITS/AIF).

We would like to make the following comments:

General questions (Please provide any evidence supportive of your response, including studies or other documentation as necessary)
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?
Q2. What issues do you see affecting the effective implementation of the policy recommendations?
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]

German investment funds are not part of the shadow banking system. They neither perform unregulated banking activities nor do they pose systemic risks or engage in regulatory arbitrage. Managers of German investment funds are authorised providers of financial services who are subject to extensive regulation and supervision adequate to their business activities.

German investment funds are bound by high regulatory standards for securities lending and repos. These standards aim in the first place at mitigating potential risks from these investment techniques by imposing counterparty risk limits and defining high standards for collateral. These existing national rules should be taken into account by the FSB and the national authorities when assessing the need for further regulatory measures.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 76 members currently handle assets of EUR 2.0 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. (BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.

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For the effective reduction of systemic risk it is indispensable that the global standards on collateralization of securities lending and repo transactions apply consistently to all market participants. In particular, it appears unacceptable to exclude some of the biggest actors in the securities lending and repo markets such as banks or broker-dealers from the scope of the numerical haircut floor regime. Such limited application might tamper the effectiveness of the entire policy framework for combating systemic risk and would negatively impact the competitiveness of securities lending and repo transactions for other market participants. Thus, we are of the view that the implementation of numerical haircut floors should be made via a market-wide regulation as proposed in the current consultation document and in the discussion paper published on 18 November 2012.

If this approach is not possible to be implemented the envisaged exemption of "regulated intermediaries" from the new standards for haircuts should also be considered for regulated investment funds (e.g. UCITS/ AIF) and fund managers acting on their behalf. It must be recognized that "direct appropriate regulation of liquidity and leverage" pertains not only to banks and broker/dealers. Regulated investment funds such as UCITS and other types of funds (e.g. AIF) are subject to even more granular rules on liquidity and leverage which are relevant for the composition of individual portfolios.

We support the proposal to introduce a general framework of numerical haircut floors which should not be set too granular and should not be based on credit ratings determined by credit rating agencies in order to avoid mechanistic reliance on external ratings. We agree with the assessment that the proposed haircut floor regime should not dictate market haircuts. The proposed haircut floor for securities against transactions is in general well calibrated and should give market participants enough flexibility to apply haircut strategy based on their own analysis.

We would like to draw your attention to the fact that German and European investment funds have to adhere to stringent provisions regarding efficient portfolio management techniques (e.g. securities lending, repo transactions). The so called ESMA Guidelines for ETFs and other UCITS issues (ESMA/2012/832) requires that UCITS has to put in place a clear haircut policy taking into account the characteristics of each asset class especially in terms of credit standing or price volatility. The collateral and haircut policy must be clearly communicated in the fund prospectus.

Given the existence of these demanding rules which effectively address many of the financial stability concerns identified by the FSB in addition to tackling issues relating to investor protection, we believe that the FSB recommendation should call upon the authorities to evaluate their national regimes in the first place in order to assess whether and to which extent further regulatory measures are needed.

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

The length of an appropriate transitional period depends upon the details of final implementing rules and the extent of associated changes to the currently prevailing market standards. In case such changes require the introduction or renegotiation of securities lending and repo agreements e.g. to ensure compliance with new haircut requirements, we would expect the phase-in period to be no less than 18 months following the adoption at national level.

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?

The suggested factors to be taken into account for setting risk-based haircuts are in our opinion very ambitious. It should be very difficult to capture all the other risk considerations and specific characteristics of the collateral as proposed in the recommendation. Moreover, the incorporation of the calculation methodologies for haircuts based on the historical or simulated volatility of assets could be very ambitious to be implemented.

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?

According to the market practice, margin and haircut requirements apply mostly on the portfolio basis. Most market participants use baskets of assets which can be chosen by the counterparty as collateral. This practice also provides for netting opportunities in case of opposing transactions. The terms and conditions generally accord to master agreements provided by ISDA or local trading bodies. The implementation of additional guidance for setting margin requirements for different counterparties/portfolios (e.g. market risk of the portfolio, illiquidity of the portfolio) should be carefully calibrated. The incorporation of additional obligation for portfolio margins could hinder market participants to calculate in time the portfolio margin requirements.

Moreover, it could be very ambitious if market participants have to provide to the competent authorities on a regularly basis hypothetical portfolios which could be used by the regulators to identify any market-wide changes in levels of margin requirements over time as any outliers firm with low margin requirements. The submitted parameters of the hypothetical portfolios could only reflect the market conditions based on historical data or appropriate time simulations covering at least one stress period.

However, as such hypothetical portfolios cannot be extrapolated in the future, we fear that the global standard setter could force market participants to use harmonized regulatory models without any possibility for the market to use own margins methodologies. Market participants should have the flexibility to develop and use their own margin requirement portfolios which are in line with the current law/market practice and with the mentioned recommendations.

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?
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?
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.

Please see our answer to questions 1 to 4.

We would like to reiterate our position that for the effective reduction of systemic risk it is indispensable that the global standards on collateralization of securities lending and repo transactions apply consistently to all market participants. In particular, it appears unacceptable to exclude some of the biggest actors in the securities lending and repo markets such as banks or broker-dealers from the scope of the numerical haircut floor regime.
Such limited application might tamper the effectiveness of the entire policy framework for combating systemic risk and would negatively impact the competitiveness of securities lending and repo transactions for other market participants.

If the envisaged exemption of “regulated intermediaries” from the new standards for haircuts is maintained for banks and broker/dealers it should also be considered for regulated investment funds (e.g. UCITS/ AIF) and fund managers acting on their behalf. It must be recognized that “direct appropriate regulation of liquidity and leverage” pertains not only to banks and broker/dealers. Regulated investment funds such as UCITS and other types of funds (e.g. AIF) are subject to even more granular rules on liquidity and leverage which are relevant for the composition of individual portfolios.

The category in table 1 “other assets within the scope of the framework” needs to be clearly defined. It is not clear which other type of assets are within the framework and apply to the haircut level of 7.5 per cent. Only a clear list of financial instruments which has to apply to the haircut level of 7.5 per cent will provide legal certainty to all market participants.

We are of the view that it is not acceptable to exclude sovereign bond collateral from the numerical haircut requirements. A number of sovereign bonds feature rather low liquidity and hence should be subject to appropriate haircuts if accepted as collateral. Moreover, in the current market environment it cannot be seriously claimed that sovereign bonds display no default risk or are generally not prone to procyclicality.

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.

We agree with the proposed haircut floor for securities against transactions. The proposed haircut floor regime should not dictate market haircuts used by the financial industry. The haircut floor regime should give market participants enough flexibility to apply a haircut strategy based on their own analysis.

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?
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?

As mentioned in our reply to question 7 to 9, government securities should be in the scope of the numerical haircut floor.

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?

We support the proposal to exclude cash-collateralised securities 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 regulation meeting the standards set out in Section 3.1 of this Document.

As mentioned above, the ESMA Guidelines already require that a UCITS has to put in place a clear haircut policy taking into account the characteristics of each asset class (including cash-collateralised securities), especially in terms of credit standing or price volatility.

Furthermore, similar standards as foreseen in Section 3.1 for the restriction of reinvestment of cash have already been introduced by ESMA for all UCITS. Under the ESMA Guidelines for ETFs and other UCITS issues, cash collateral received from securities lending can be either placed on deposits, invested in high-quality government bonds, used for repo transactions with regulated credit institutions, or invested in short-term MMFs. These restrictions on cash-collateral reinvestment effectively eliminate the risk of maturity and liquidity transformation challenged by the FSB. Similarly, due to the requirement for non-cash collateral not to be sold, re-invested or pledged and be held by the UCITS depositary in case of title transfer, re-hypothecation of assets received as collateral is generally excluded.

Therefore, given the already implemented regulatory framework for the haircut policy on cash-collateralised securities transactions for UCITS, we are of the opinion that the future regulatory regime for the haircut policy in the EU should exclude cash-collateralised securities transactions from any proposed framework of numerical haircut floors. In this case the ESMA Guidelines should be amended accordingly.

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, we agree with this position.

We act on the assumption that the scope of the application implies that the standards should not pertain to cash obtained through repo transactions and such cash proceeds should not be treated as collateral.

At EU level ESMA has taken a stance in the context of the UCITS regulation according to which cash received by UCITS in the course of repo trades shall be treated as collateral and shall be bound by the same restrictions on reuse or reinvestment. This effectively eliminates the possibility for UCITS to use cash from repos for collateralisation of OTC derivative transactions and hence makes it very difficult to participate in the central clearing of OTC derivatives where cash collateral is needed for the provision of the variation margin.

We are convinced that proceeds from repo transactions should not be treated as collateral from both legal and economic perspective. Legally speaking, the concept of repos is clearly different from

securities lending as it provides for the transfer of the economic ownership of the relevant assets subject to a repurchase obligation at a future point in time. Repos can be concluded in one deed or by means of two separate buy and sell-back agreements where the nature of the transaction as a genuine purchase contract becomes even more evident. From the economic point of view, repos are predominantly used by European investment funds as financing transactions e.g. to bridge liquidity gaps in a more cost-efficient way than unsecured bank credits. This is a profound difference to securities lending which serves the sole purpose of generating additional profits for the fund from the lending fees or interests on cash collateral. Under the approach adopted by ESMA, UCITS might be effectively forced to engage in collateral upgrade transactions involving additional fees and potentially creating further counterparty risks.

Another possibility would be to avoid as far as possible central clearing by concluding non-standardised OTC derivatives which are cleared in a bilateral manner. This solution, however, would counteract the G20 objective of extending the central clearing of derivatives and raise insolvency risks which could be avoided in the CCP model.

Therefore, it would be very helpful if the FSB could clearly state in its policy recommendations that the principles for cash collateral reinvestment have no impact on cash obtained from repo transactions.

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.
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?

We agree with the FSB assessment.

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?
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?
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.

Please see our answers to questions 1 to 4.

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.

The implementation time for the proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions should be coordinated with the progress made on EMIR. EMIR requires that non-centrally cleared OTC derivative transactions need to be collateralized. BCBS/IOSCO published their final principles in September 2013. These principles also include a standardized haircut schedule which is different from the proposal made by the FSB. Therefore, a harmonized numerical haircut floor should be implemented globally in order to ensure consistency and legal certainty for all market participants.