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***Re: FSB Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos including the Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions***

Dear Sir or Madam,

Deutsche Bank welcomes the opportunity to provide comments on the above consultation.

We support the FSB's objectives of limiting the build up of excessive leverage outside of the Banking system and reducing procyclicality. We welcome the FSB taking into account the concerns of market participants expressed in response to the first consultation and the proposal of more balanced minimum methodologies and numerical haircut floors. We have suggested changes which we believe would increase the effectiveness of the framework.

Although they are not subject to consultation, we would also like to make some suggestions on factors that should be taken into account during implementation of the finalised recommendations contained in the first part of the report.

- **Improvements in transparency:** We believe that the existing data should be relied upon where available and the data requested should be fit for purpose i.e. requesting trade level data (if at the beneficial owner level), will result in regulators receiving millions of transactions each day. Normalising and interpreting this data will be very difficult.
- **Securities financing:** Several terms contained in the recommendations require further clarification.
- **Market structure:** Securities financing transactions will grow as a result of increased central clearing in derivatives. Further broadening the scope of CCP activity to cover non inter-dealer activity (or dealer activity where the dealer is an agent) would be challenging and costly to introduce with little policy benefit. Concentration of risk within CCPs could be an unintended consequence.



We trust you find these comments helpful. Please let us know if we can provide further information.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'A. Procter', with a long horizontal stroke extending to the right.

Andrew Procter  
Global Head of Compliance, Government and Regulatory Affairs



## Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions (for public consultation)

### 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?**

We welcome the recognition that high minimum numerical haircuts would risk becoming market benchmarks. Overall, the FSB's near final proposals represent a balanced approach. Subject to some amendments and clarifications, the proposed methodologies and numerical haircuts could play a supporting role alongside prudent risk management processes and contribute to limiting the build up of excessive leverage outside of the banking system and the reduction of procyclicality. Further, when considering whether the proposals will be effective in meeting the policy goals it is important to consider that they are being accompanied by a combined body of measures on capital, leverage, liquidity and counterparty risk.

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

As drafted, the proposals are balanced and proportionate. Effective implementation would be negatively impacted if jurisdictions go beyond the numerical floors set out in the FSB proposal and thereby dis-incentivise the use of a secured funding source which the FSB has attempted to preserve by refraining from setting numerical floors at too high a level. Stricter national rules would also create inconsistent global implementation of the recommendations with the consequent possibilities for arbitrage negatively impacting their effective implementation.

Before finalising and implementing the framework, regulators should ensure that proper account is taken of the results of the second Quantitative Impact Study (QIS2).

**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]**

Deutsche Bank will be responding to the QIS2. Our response to the first consultation identified the potential unintended consequences of numerical floors for haircuts if set at too high a level:

- Institutions could opt to undertake unsecured lending because secured lending and repo is made too costly. This is in contrast to the incentives sought to be created by the Basel III framework.



- Mandatory minimum levels, in excess of those used when lending to highly credit-worthy counterparties, would reduce the incentive to lend to credit-worthy customers, and thereby potentially increase systemic risk.
- Despite the FSB's intention to monitor the situation there remains a risk that numerical floors become de-facto market benchmarks.
- The risks that the proposed numerical floors intend to allay are extensively mitigated within the regulated banking sector by Basel III liquidity standards, Basel 2.5 and Basel III credit and market risk requirements, Basel II standard supervisory haircuts and the ongoing Fundamental Review of the Trading Book.

These risks will persist unless the floors are ultimately implemented at true backstop levels at national level in line with what the FSB has proposed in this consultation.

***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.***

When assessing the impact of mandatory minimum haircuts on the regulated banking sector, the FSB should consider the cumulative impact of its proposals with other measures on leverage and liquidity and BCBS and IOSCO final requirements for collateralisation of non-cleared derivatives. The cumulative effect of these measures will result in significant changes to the availability and use of collateral globally.

We note that the BCBS-IOSCO requirements on two-way exchange of initial margin will be phased-in over four years to mitigate the impact on liquidity. A similar approach would in our view be appropriate for the implementation of the FSB's haircut proposals.

Further, we would recommend that the FSB incorporates a "monitoring period" to assess the impacts of its proposals. (The approach used in updating the Basel framework and the intended "monitoring group" envisaged in the final BCBS-IOSCO requirements on margining for non cleared derivatives could serve as an example).

**[2. Minimum standards for methodologies used by market participants to calculate haircuts](#)**

***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 most important factors have been captured by the proposal. Counterparty creditworthiness is an important consideration for many firms and should be included but as drafted, the proposed haircut methodology appears to ignore it. As historic haircuts would have taken into account counterparty risk alongside collateral price volatility, this could significantly distort future haircut levels. We support the inclusion of a period of stress in the time series of price data and a rolling period which captures more recent market behaviour.

It is important that the FSB take into account that liquidity risk is very difficult to incorporate into haircut methodologies due to the lack of appropriate historical data. Information on liquidity is already captured by incorporating a period of stress into the historical data. Sudden falls in market prices during periods of stress are already a reflection of liquidity, rather than a fundamental change in the underlying economics of the issuer i.e. during a crisis period, there is a large fall in market prices of some stocks



and bonds because there is simply no demand. Expected liquidity in times of stressed conditions is a subjective assessment and is also difficult to incorporate, with potentially very large differences between institutions, rendering any dispute resolution process very cumbersome.

Under the proposed framework, the following financing transactions would be out of scope for minimum numerical haircuts:

- (i) financing transactions where the receiver of cash is a bank or broker-dealer (“entities subject to regulation of capital and liquidity/maturity transformation”);
- (ii) financing transactions where the collateral is government securities;
- (iii) financing transactions where the receiver of cash is a central bank; and
- (iv) centrally cleared financing transactions.

The FSB proposed these exemptions as these transactions are already subject to considerable regulatory scrutiny or do not suffer from the weaknesses that covered transactions might suffer from. Using the same logic, these transactions should also be excluded from the scope of the minimum methodology standards to be used by market participants in order to ensure that there is consistency with the scope of the minimum numerical floors. There is, otherwise, a danger that the methodology requirements will result in an effective minimum haircut floor for the transactions exempted from the haircut framework. It may also lead to an adverse impact on the securities lending markets because legislation often prevents the lending of securities unless the lender receives collateral to at least the same value as the securities being lent.

### **3. Additional guidance for methodologies used by market participants to calculate margins on a portfolio basis**

***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?***

In addition to the described standards for portfolio margin, credit clauses (NAV triggers, key man risk, margin timing) within the legal agreement and counterparty credit risks are also relevant and should be included. Internal methodologies which capture account liquidity, concentration and pro-cyclicality could also be used.

Consistency with the BCBS-IOSCO proposals on haircuts for initial margin is important especially with regard to the requirements on stress testing and back testing.

### **4. Numerical floors on haircuts**

#### **4.1 Scope**

***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 agree with the FSB clarification that the numerical haircut floors are intended to apply to transactions where the primary motive is to provide financing to entities not subject to regulation of capital and liquidity/maturity transformation, rather than to borrow/lend specific securities.



Further clarification is important however regarding the definition of a securities financing transaction. A purpose test relying on representations by the counterparties could be used to identify securities financing transactions.

Regarding the recommendations, it could also be clarified that minimum standards for cash collateral reinvestment include CCPs.

***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?***

The proposed scope of application could play a supporting role in limiting the build-up of excessive leverage outside the banking system and reducing procyclicality of that leverage alongside prudent management of counterparty credit risk.

When considering the effectiveness of the numerical haircut floors, portfolio margining should be distinguished from securities lending. Portfolio margining covers products that will be subject to CCP margin requirements and non-cleared derivatives products which will be subject to BCBS-IOSCO non-cleared margin requirements. When these requirements are considered the cost of lending to clients will increase, possibly substantially. Whilst some strategies may be able to absorb this increase, others will not and, as such, there will be a negative impact on liquidity.

We accept the FSB's rationale for exempting securities financing transactions backed by government securities i.e. price movements in these securities tend not to be pro-cyclical, haircuts on these transactions have been comparatively stable over time, and imposing numerical haircut floors on these transactions could have a large negative impact on the liquidity and functioning of core funding markets.

***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.***

It may be duplicative to apply numerical haircut floors to transactions where the financial entities receiving securities financing are subject to the regulation of capital and liquidity/maturity transformation. We understand the decision to exempt other entities from scope and establish a monitoring framework and keep under review any potential growth in transactions between unregulated entities.



## **4.2 Proposed levels for numerical haircut floors**

***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.***

As noted above, the minimum methodologies and the level of numerical haircuts currently proposed could play a useful role alongside prudent risk management if they are set and maintained at true backstop levels during implementation. This management along with the many other measures around capital, leverage and liquidity adequately limit the build up of excessive leverage outside the banking system and reduce procyclicality.

For portfolio margining however, depending on the definition of securities financing transactions, the 4% haircut proposed for main index equities could be problematic for US stock loans where margin levels would be doubled from the current 2% if the transaction is deemed to be in scope. This would have an impact on funding and the cost of borrowing and could dis-incentivise this secured form of funding which would be contrary to the regulatory objective being pursued. We recommend that clarity is provided on what is a securities financing transaction in order to assess the impact that the proposed numerical floor would give rise to and what the appropriate level should be.

***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?***

Many aspects need to be considered when determining haircuts. Credit risk management. Counterparty, credit and liquidity risk are all important features to 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?***

In the context of other regulatory regimes around margin (e.g. the BSBS-IOSCO margin requirements for non-centrally cleared derivatives), application of these floors to a portfolio margining methodology will become increasingly complex to manage.

We recommend adding a new category to the proposed haircuts schedule to address positions where a dynamic hedge on an investment addresses the risk on another investment. An example of this could be a position held via a swap that is offset by a position held in the underlying asset. In this instance the haircut level should be zero. This additional category should be applied to portfolio margin only.



#### **4.3 Cash-collateralised securities lending**

***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 welcome the proposed exemption concerning cash collateralised securities if the lender of the securities reinvests the cash collateral into a separate reinvestment fund and/or account subject to regulation.

However the borrower of stock is not privy to details of how the lender is reinvesting any cash collateral and as such, the borrower, when providing cash collateral would not be able to determine whether the transaction was a trade within scope or out of scope.

Therefore it is important to clarify that borrowers can rely on the representations by lenders regarding their intention to invest in a separate re-investment fund.

***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?***

In general, there should be a distinction between any unregulated securities lenders acting on its own behalf, and those that are being serviced by a regulated entity acting as their agent. We believe that an exemption from the numerical haircut framework would be appropriate where the securities lender is being serviced by a regulated entity acting as their agent - especially where the agent provides a fully-inclusive margin shortfall indemnity and as a result, is making sufficient capital provision. The cash collateral is not being made available to the unregulated entity to use for their own purposes and should not therefore be in scope of the framework. Further, in the event of the securities lender becoming insolvent, the borrower would be free to sell the asset they hold and would then be a creditor for any excess margin that had been provided.

However, with non-prudentially regulated securities lenders acting independently, it may make sense to include them in scope and not apply an exemption depending upon the quality of the security loaned and the securities lender themselves.

#### **4.4 “Collateral upgrade” 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.***

As collateral is managed on a pooled basis it would be challenging to apply the FSB treatment effectively as there will be significant difficulties associated in monitoring transactions to determine if they are upgrades within scope of the regime. For example, in a situation where equity collateral is exchanged and government collateral is received by the borrower, the government collateral could then be lent out to the market and this





would not attract a haircut. It is not clear how this could be effectively monitored. The alternative would be to focus on applying haircuts to the lesser quality collateral.

***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?***

Such an approach would effectively prevent lenders from rehypothecating non-cash collateral. In principle we would support this approach provided that it does not increase the cost to borrow or impact negatively on liquidity. Further examination of this appears to be required.

There should however be an exemption when a regulated securities lending agent subject to regulation of liquidity /maturity transformation is used. Further, lending via an agent would result in only one further use of collateral; for margining of CCPs.

#### **4.5 Implementation approaches**

***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?***

Our response to the first consultation identified an increase in systemic risk as an unintended consequence if the numerical haircuts were set at high levels and became market benchmarks. While we note that the FSB will monitor for signs that numerical floors are becoming de-facto market standards, we believe that this remains a significant risk inherent in prescribing minimum haircuts, unless they are set at true backstop levels. Minimum haircuts could also increase the credit exposure of borrowers, which may aggravate system risks in stressed situations.

A significant unintended consequence of minimum haircuts could be that any transactions taking place below the haircut floor in both the repo and secondary markets would be dis-incentivised. This would have a directly opposite effect to other regulatory initiatives, which attempt to promote and sustain the health of collateralised lending. Furthermore, increasing the cost of secured financing in relation to the alternative (i.e. unsecured lending transactions) could have perverse effects.

***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?***

We note that authorities will be expected to implement the framework in national law and the BCBS will review its capital treatment of securities financing transactions and amend it so that where firms that are subject to prudential regulation choose to conduct business with a haircut lower than suggested by the framework, they must allocate appropriate risk based capital to the transactions and this acts as an alternative brake on the build-up of leverage.

The impacts of any haircuts on reducing procyclicality and limiting the build up of excessive leverage outside of the banking system will therefore depend on national



implementation and how the revised BCBS rules on capital treatment would apply in practice.

***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.***

There are transactions whereby stocks can be borrowed or repurchased on an uncollateralised basis. Clarification is required as to how this rule would be applied if the lender of stock receives zero collateral.

In addition, whether a transaction is deemed to be for the purpose of financing depends on the definition of securities financing transactions. As previously stated we would welcome clarification of this.

***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.***

Please see our response to question 4.