Japan Securities Dealers Association
JSDA

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

RE: Comments on the Consultative Proposals in the FSB's "Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (Published August 29, 2013)"

Dear Sir/Madam:

The Japan Securities Dealers Association (JSDA)[1] appreciates the opportunity to submit comments on the consultative proposals in the "Financial Stability Board (FSB)'s Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" of the policy recommendations to strengthen the oversight and regulation of the shadow banking system published on August 29, 2013.

General Comments

• It is necessary to weigh the purpose or the advantages of the introduction of regulatory requirements against its associated drawbacks, and find a proper

[1] Japan Securities Dealers Association (JSDA) is an association functioning as a self-regulatory organization (SRO). Its legal status is a Financial Instruments Firms Association authorized by the Prime Minister. Today JSDA comprises around 500 members consisting of securities firms and other financial institutions operating securities businesses in Japan. It also acts as an interlocutor for the securities industry between the market participants and other stakeholders, separately from its self-regulatory functions.
As a fully empowered SRO, JSDA extensively regulates market intermediaries. Its self-regulatory functions encompass rule-making, enforcement, inspection, disciplinary actions, accreditation of sales representatives, and dispute mediation.

balance between them. In pursuing the current policy recommendations' goals of limiting the build-up of excessive leverage outside the banking system and reducing procyclicality, the importance of maintaining market liquidity and well-functioning of market should not be neglected. If the ultimate goal of the policy recommendations is to prevent the recurrence of a financial crisis, then utmost consideration must be given to the risk that excessive regulation might cause a decline in market liquidity and impairment of market function, which could bring on another financial crisis.

• In introducing the regulation, it is essential to consider optimization of the overall regulatory frameworks rather than considering each regulation individually; excessive or duplicative regulation would impair the efficiency of financial sector. In this perspective, for the policy recommendations for securities lending and repos, it will be necessary to give due consideration for consistency with other international regulatory initiatives, including margin requirements for OTC derivatives, capital ratio, and liquidity requirements for banks and securities companies, and preclude any overlapping among these regulations.

• The "minimum standards for methodologies used by market participants to calculate haircuts (hereinafter 'methodology standard')" and "numerical floors on haircuts (hereinafter 'haircut floors')" proposed in the recommendations operate alongside each other. While there are overlaps in the scope of transactions to which these regulations would apply, no clear indication has been made for the regulatory position of the methodology standard, nor the priority order between the two policies . If the "methodology standard" becomes a regulation, it is undesirable from a practical point of view to allow differences between the haircut floors, in its scope of application or haircut levels. From this perspective, further discussion should be made to improve the consistency of the two requirements: government securities repos and other transactions, which are excluded from the scope of the haircut floors, should also be exempted from the methodology standard. Even in the case that these transactions are not excluded from the scope of methodology standard, it should be made clear that the methodology standard is a reference. In addition, the priority order between the two policies or a practical interpretation of them should be provided in detail so that it can be understood that the minimum required haircut is zero for the above mentioned government securities repos and other transactions.

• Transaction schemes for securities lending and repos and related market practices differ across jurisdictions. Even under the unified purpose of limiting the build-up of excessive leverage outside the banking system and reducing procyclicality, the appropriate methods of regulations may also differ. Accordingly, when introducing regulations in each jurisdiction (especially regarding the specific details of the methodology standard), sufficient discretion should be allowed to regulatory authorities in each jurisdiction in forming standards in accordance with market nature and practices in their jurisdiction. This point should be clearly stated in the final report.

Comments on Individual Questions

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

• Since it will be necessary to review many aspects for the implementation, such as system developments by market participants, change in market practices and transaction contracts, an adequate preparation period should be given to address these points. A rough-and-ready introduction of the policy recommendation should be avoided in order not to trigger market turmoil. The methodology standard in particular will require adequate time for discussion among the relevant parties and a sufficient period (in some cases several years) should be given to adapt systems.

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?

• We agree that centrally cleared securities financing transactions should be excluded from the scope of the framework. If regulations were formulated for centrally cleared securities financing transactions, it would result in some overlap with the existing regulations on initial margin and clearing fund of centrally cleared securities financing transactions. Such regulations would be undesirable, because they would lead to a fundamental revision of the central clearing system itself.

• In current market practices, the risk of fluctuations in the collateral price in non-centrally cleared securities financing transactions is controlled overall by haircuts, margin calls, and risk management by each participant in the transaction. The current recommendations focus on haircuts, but of course, there is no need to manage all risk aspects through haircuts. If procyclicality has not been observed for the specific type of collateral, <u>the risk of price decline of these collaterals should be managed not through haircuts, but through the steady implementation of margin calls and ordinary risk management by transaction parties.</u>

• There is no doubt that a conservative approach should be taken with liquidity horizons. On the other hand, for liquid securities, which intraday liquidation can be expected in ordinary cases, setting an extremely conservative liquidity horizon is unnecessary and could conversely act as a barrier to market liquidity. Another possible approach is varying the liquidity horizon according to the frequency of margin calls (in other words, setting short liquidity horizons for high frequency margin calls, such as daily margin calls).

• The recommendations suggest that haircuts should not only reflect the risk of price fluctuation of collateral, but also take into account the liquidation risk for large concentrated positions and even "wrong-way risk" between collateral value and counterparty default. However, this raises the concern that the scope of risk requiring haircuts will expand excessively. Liquidity risk and "wrong-way risk" should be dealt with through the risk management of transaction participants (stress analysis, requiring additional haircuts and/or collateral replacement, hedging, and other measures) and there is no need to substantially change current market practices. Sufficient consideration should be given to the concern that excessively expanding the scope of risk that haircuts should cover could increase costs for collateral funding for market participants and have a serious impact on market liquidity.

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?

• In the proposed scope of application, we agree that it should be limited to 1) non-centrally cleared securities financing transactions, 2) financing received by entities not subject to regulation of capital and liquidity/ maturity transformation from entities subject to such regulations, and 3) transactions involving collateral other than government securities. In refining policy framework, due considerations should be given to the market practices and conditions of securities lending and repos in order to avoid excessive regulation.

• Because a degree of ambiguity remains about the scope of application, a greater clarification would be needed for its practical application. For example, with the term "entities subject to regulation of capital and liquidity/ maturity transformation," it is not clear whether it should be interpreted as all categories of financial institutions subject to some form of capital and liquidity requirements, including banks, securities and insurance companies. If the details including the definition of the term are to be left to the discretion of each jurisdiction, this should be indicated clearly in the final report.

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?

• In the light of the purpose of limiting excessive leverage and reducing procyclicality while maintaining market liquidity and appropriate function, we believe the proposed scope of application for numerical haircut floors is appropriate. Particularly with government securities, as indicated in the policy recommendations, price movements in these securities tend not to be procyclical. Imposing a uniform haircut floor would prove an obstacle to standard financing transactions that have no leveraging purpose, creating the concern that it would have a burdensome impact on the liquidity and function of the market. In that sense, we strongly support the decision to exclude government securities from the proposed scope of application for numerical haircut floors.

• The proposed numerical haircut floors adequately cover the scope of transactions required in the light of their previously mentioned purpose. We do not see the necessity for any further expansion of the scope. Rather, there may be some room for further focusing the scope.

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.

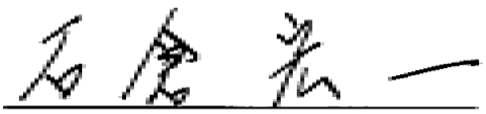
- Except for certain jurisdictions, the securities lending and repos markets collateralizing securities other than government securities are in their development stages in most countries and regions. If in the future, the numerical haircut floors were made more conservative (i.e. raised) in these countries, a strong concern would be caused about a negative impact on the sound development of the market and strengthening of its functions. In this perspective, we believe that, in principle, there should be no future changes in the numerical haircut floors, and even if they were being considered, it should be done with great care after adequate discussion. This not only applies to the numerical haircut floors, but to the overall proposed regulatory framework; any possible negative impact on the sound development of markets and strengthening of their functions needs to be carefully considered.

Q13. What are your views on the merits and impacts of exempting cash-collateralized securities lending transactions from the proposed framework of numerical haircut floors if 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?

- The recommendations state that “special repos” should not be exempted from the scope of proposed numerical haircut floors. However, the motivation for general collateral and special repo transactions are different: GC transactions are mainly used for procuring funds while special repos are primarily used to serve securities borrowing needs. Considering one of the purposes of implementing the current policy recommendations is to limit the buildup of excessive leverage, it should be sufficient to make only GC transactions subject to the requirements. Therefore, we believe that, similar to other cash collateralized securities lending transactions, special repos should be exempted from the scope of regulation.

In conclusion, it is our hope that the JSDA's comments described above will prove useful to the process of producing the FSB's final report. Please feel free to contact us should you encounter anything unclear in the comments.

Sincerely yours,



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