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Reply to the Financial Stability Board consultation on a
Policy Framework for Addressing Shadow Banking Risks
in Securities Lending and Repos

Involved in the running of Securities Lending & Repo desks and businesses with Hedge Fund Managers, Investment Managers, and Agent Lenders for a decade, I welcome the opportunity to respond to the consultation organised by the Financial Stability board on a "Policy framework for addressing shadow banking risks in securities lending and repos".

As a consultant I now focus on Securities Lending and Repo matters.

I believe Securities Lending and Repo markets plays a fundamental role in the well-functioning and liquidity of global markets and I would like to contribute to the important work undertaken by the FSB to address shadow banking risk in Securities Lending and Repo markets.

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?

In my view, the approach taken by the FSB to reduce systemic risk by limiting the build-up of leverage in stable market conditions, i.e. by implementing numerical haircut floors, might impact the efficiency of the global markets by reducing the liquidity and the refinancing capacity of the cash markets – see Questions 5, 8, 9, 10 and 13.

I am also of the opinion that an important factor of systemic risk in this context is the speed at which the haircuts are raised, not only the magnitude of the increase – see Questions 5 and 8.

With regards to risk mitigation in the overall system, I believe that another approach would be to address the gross exposure to one single counterparty, which in case of a default could lead to unmanageable losses and to a chain effect – see Question 5.

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

One of the main issue I see is that Securities Lending and Repo transactions seems to receive the same treatment. However, in the purpose of protecting the final investors of the beneficial owners, the market practice in the Securities Lending industry is to overcollateralise the securities lender. Implementing haircuts in the Securities Lending market would be disruptive and might limit the appetite for this business. The overall impact on the well-functioning and liquidity of the global markets could be significant.

Q3. Please address any costs and benefits as well as potential material unintended consequences arising from the 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.

See Question 1 & 2

Also I am of the opinion that imposing minimum haircuts to the underlying private sector whilst the public sector is exempted creates an asymmetry that may seriously impact the efficient allocation of resources in the Global Markets and dampen the real economy.

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

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?

I think that one other aspect that should be considered is the Gross Exposure to one single counterparty in order to avoid chain effects. Indeed, when a default event occurs the potential loss becomes less manageable with the size of the collateral that needs to be liquidated. Including this criteria would tend to limit the building of excessive leverage against one counterparty, protect the market and allow for an efficient and competitive funding market.

An other consideration I would like to discuss is the scope of applicability of the minimum standards described in Section 2. I understand that this methodology intends to "mitigate the magnitude of the potential increase [of haircuts] in volatile markets" by "moderating the decline of haircuts in more benign markets".
However, where I see the risk in stressed markets is when arbitrary sudden spikes in the haircuts are set in urgency. When I use the term "arbitrary" here, I mean that those applied haircuts are higher than the one defined by the model. I would advocate to mitigate not only the magnitude, but also the speed of the potential haircut increase.

With regards to the underlying models, I am of the opinion that models that exclude the tails are not

suitable to manage collateral risk.

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?

Please see my answer to Question 5.

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?

Yes. Particularly with regards to the situation of the buy-side industry in Europe.
Securities Lending and Repo transactions are already governed by an extensive set of regulation – UCITS, ESMA Guidelines on ETFs and Other UCITS issues – that prevent from the build-up of excessive leverage and thus applying numerical haircuts to these entities may be duplicative.

Q8. Would the proposed scope of application for numerical 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?

I understand that the purpose of minimum haircuts is to limit the magnitude of their increase in more volatile markets. Independently from the chosen levels for the haircuts, I see limitations in the use of any minimums.
Regulatory minimums tend to become market standards, hence I would advocate that whilst the market environment would justify somewhat higher haircuts, the market would stick with those minimums and would generate excessive build-up of leverage in that environment.
In the other hand, minimum haircuts would jeopardise liquid and well-functioning markets when risk-based models would determine lower haircut levels. In this situation minimum haircuts might reduce price discovery mechanism and market resources allocation efficiency by limiting market liquidity.
Like the minimum standard methodology for risk-based haircut, I believe that one issue that needs to be addressed with the magnitude of haircuts increase is the speed of that increase in order to avoid brutal shortage of liquidity/collateral.

I think minimum haircuts should not be expanded and actually shouldn't be applied.

Q9. In your view, what would be the impact of introducing the numerical haircut floors only on securities financing transactions 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.

In my view, applying numerical floors to only one segment of the industry will reduce market efficiency by limiting fair competition and the offer to non-regulated entities where haircuts will not be determined by market forces or risk appetite but externally.

Also, by reducing re-financing capacity of a sub-set of assets it may have counterproductive impact on the cash side of the market and limit the cash market efficiency. This may have significant drawback that need to be carefully assessed.

There is indeed arbitrage opportunities for regulated entities. If the inter-regulated market prices lower haircuts then regulated entities can repo-in assets at the higher haircut and repo-out at the lower haircut generating excess liquidity. Beyond the arbitrage issue it-self, it could lead to excessive leverage on those less liquid assets. I then think this situation would be pro-cyclical and would add systemic risk.

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.

Please see Question 8 regarding my opinion about the use of numerical floors in general.

As discussed earlier, I suspect that regulatory numerical floors might soon become market standards. If this is the case, then the bucket aspect might lead to more risk in the system. Indeed when refinancing assets, one would look at refinancing first the less liquid assets available within one bucket. The market would then build-up excessive leverage on the less liquid assets which would add to systemic risk when those assets need to be liquidated.

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?

I think the market should set the haircuts without being limited by numerical floors for the reasons explained above.
Also, I think that the additional factors are better handled by risk-based models.

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?

My view is that there is value in relaxing haircuts constraints at the portfolio level. Using risk-based haircuts on the portfolio and allowing the haircuts to be below the weighted average of the numerical floors would encourage participants to create higher quality collateral mix, hence lowering systemic risk at time of liquidation by providing uncorrelated assets.

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 the lender of the securities reinvests the cash collateral into a separate reinvestment funds 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?

I would welcome this approach.
However I want to emphasised that "numerical haircut floors" in the context of Securities Lending are not in line with market practice. Market practice requires the lender to be overcollateralised at all time. That is in contradiction with using haircuts on the loaned securities.
This intends to protect the final investor and allows the Beneficial Owners to use efficient portfolio management techniques in a low risk environment. Shall this safe environment be negatively impacted and the Securities Lending practice by Beneficial Owners might be seriously reduced, hence jeopardising market liquidity.

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?

I would welcome this approach.
I believe that haircuts shall not apply to Securities Lending – see question 13.
In the current context and the implementation of EMIR, the capacity to re-use cash collateral to meet CCPs margin requirements would be beneficial to the market.

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.

Whilst I think the approach is in line with the concept and goals of the numerical floors, I believe the simple difference of the two haircuts is not appropriate.
With :

– $H_{upgrade}$: the haircut applied on the collateral upgrade trade,
– H_{low} : the lowest haircut, applied on the higher quality security,
– H_{high} : the highest haircut, applied on the lower quality security.

The no-arbitrage condition is:

$$\frac{\frac{1}{1+H_{upgrade}}}{1+H_{low}} = \frac{1}{1+H_{high}}$$

$$\Leftrightarrow 1+H_{upgrade} = \frac{1+H_{high}}{1+H_{low}}$$

and finally:

$$\boxed{\Leftrightarrow H_{upgrade} = \frac{H_{high}-H_{low}}{1+H_{low}}}$$

with $\quad H_{upgrade} \leq H_{high} - H_{low}, \forall H_{low} \geq 0$

If we apply this result to the example used in the document we have for the upgrade trade "main index equities Vs under-one-year corporates":

$H_{low} = 0,5\%$, *under-one-year corporates haircut*

$H_{high} = 4\%$, *main index equities haircut*

and

$$H_{upgrade} = \frac{4\% - 0.5\%}{1 + 0.5\%} \approx 3.4826\% \quad < 3.5\%$$

Depending on the specific haircuts used, the impact could be significant.

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?

In my view there is no fundamental differences in re-using cash collateral or non-cash collateral to meet CCPs margin requirements.
So I would welcome the same approach than the one taken for cash collateral.