Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

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FSB Consultation on Strengthening Oversight and Regulation of Shadow Banking – Securities lending and REPO

Information about the ABBL (Luxembourg Bankers' Association):	
Identity	Professional Organisation
Capacity	Industry trade body
MS of establishment	Luxembourg
Field of activity/ industry sector	Banking & other financial services
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Introduction and general remarks

The ABBL[1] welcomes the FSB's for the open consultation and would like to share some general ideas before going into the different specific questions.

The ABBL is preoccupied with a few issues raised by the different regulatory work streams on shadow banking. Firstly, banks, which are primary lenders to the economy in the EU, are confronted with the imposition of Basel III requirements and its EU version, the CRD/CRR IV (capital requirements directive/regulation), which will because of its side effects limit lending opportunities. And while they may have

1 The Luxembourg Bankers' Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members' universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.

previously been able to externalise some of the risks via securitisation, the shadow banking regulatory agenda will more than likely render many of these options more complex, costly and perhaps even riskier. The second major concern is that in a world where centralised clearing for OTC traded derivatives becomes the norm, a prudent approach may be to leave the doors open for an easy access to collateral as well as possibilities to mobilise assets for collateral purposes, this presupposes to take a careful approach to regulating both the market segments and market operators. A third element of concern for the ABBL is that in its view, each layer in a depositary/custody chain shall be responsible for its clients and assets: expecting that the institution at the top of the chain of depositaries/custodians knows at all times where assets are located is most likely very time consuming and adds unnecessary complexity to the already complex world of depositaries and custodians and above all it may not impact client's rights. It shall be noted that in the vast majority of jurisdictions the financials assets in form of securities are off the balance sheet of the financial institution and then bankruptcy remote. It should be added that the benefits in terms of efficiencies of these layered responsibilities largely compensate for the reduced supposedly reduced information which by the way does not impact clients rights. This being said the ABBL thinks that the minimal standard should be client information, disclosure and agreement in case assets are reused.

The ABBL does not share the views expressed in chapter 1 of the document. The risks identified are indeed major but the conjunction of all factors that would lead to their occurrence is not met in most day-to-day business and even in crisis mode they may not fully materialise. The view taken is the one of an extreme market under extreme conditions. Furthermore, the fact that securities are fungible may mean that a client who has authorised his assets to be rehypothecated or reused shall be indifferent to receiving his/her securities or identical ones. In a worst case scenario, if the client receives an equivalent amount of cash to the value of its holding, this should not be detrimental in most cases, perhaps to the exception of potential trading costs for again

buying his/her securities. The ABBL thinks that a good knowledge of a client at each layer of the custody chain may prevent or downplay many of these concerns. The ABBL does not agree with the last point 1.2.v.: the ABBL would like to remind that accounting is a view taken at a given moment in time, some of the MBS have indeed taken important hits when mark to market,… with no market, but at the same time they – at least some - fully recovered their loss the following years which created volatility in earnings on products that otherwise were paying interests.

The ABBL understands the concern over large exposures and the interconnectedness of financial institutions, but at the same time a risk weighted approach may be superior in terms of network efficiencies than bans or limitation at a time where so many uncertainties surround the access to collateral, for regulatory purposes (Dodd Frank or EMIR).

A last concern is that for many of these transactions a bank will be identified as a counterpart, an entity already subject to a completely renewed prudential framework which will include not only risk weightings but two important factors for managing short term and medium term liquidity. These last 2 elements may be more informative and be tools to understand and shape the liquidity funding. Banks have always been managing maturities between depositors and creditors and it is through the use or reliance on alternative sources of funding that banks were able to support economic development. The ABBL therefore has some sympathy for the application of these recommendations for non-bank entities only, but there still a need to define what these are, ideally they shall be non-financial institutions and/or not regulated.

Comments on recommendations

Recommendation 1

The Association agrees that a better use of current data is the most optimal route to pursue. Investment firms and other financial institutions are already reporting a lot of information and before requiring new reports which are always costly, it would be useful to first work out what can be achieved with the flows of information that are already available.

Recommendation 2

The ABBL has always believed that good information is superior to data overflow. Knowing more about a transaction may be helpful in theory, however, one has to be able to manage the information and identify triggering factors. It is probably true that trade repositories may help in identifying certain transactions, but a REPO is a contract where each party may, according to commercial and property rights, use the proceed of the transaction to its own discretion, provided it is able to close it at a later stage.

Recommendation 3 & Recommendation 4

As long as firms only have to provide raw data that are then processed and analysed both recommendations are agreeable.

Recommendation 5

The ABBL does not believe that this information is of material use for retail investors; the expected beneficiaries are most likely to be competitors. Indeed, several studies done at EU level by regulatory/supervisory authorities have shown that investors have

difficulties fully understanding basic information presented in the simplified disclosure documents (KIID for UCITS or future PRIPS) therefore taking this position would assume that the concept of reuse is considered known by investors for that information to be of any value. In addition, in the EU both UCITS KIID and PRIPS require the use of a common/ jargon-free language what may not be compatible with this requirement.

Recommendation 6

With the view of representing banks, the requirement that these different items only apply to banks and thus avoid double constraints on a counterpart is a good principle. The argument is that the bank side of the trade shall be covered via the prudential regulation and specific sector regulation, including in reporting terms. Having said this, the ABBL does not see any merit in imposing the immobilisation of a portion of cash collateral. At a time when economies need all the help they can get, it is not a great idea to sterilise portions of cash in an unproductive manner. The Association disagrees with a brute approach of minimising mismatch. The concept should not be as presented one per one, meaning that lending at 20 years should all be covered by funding at 20 years, what needs to be secured is a plan to access a pool of liquidity to avoid mismatch.

Recommendation 7 & Recommendation 8

It is difficult to disagree with the principles of ensuring a good level of information and disclosure, but when it comes to the details, the ABBL believes that too much information kills the information. Clients are overloaded with details, which are costly to produce, but they hardly use the information. The option would be reporting on a yearly basis or on ad hoc demand and emphasis should be put on the preliminary contractual information. Risks and benefits as well as a description of the transaction of reuse

should be explained but a daily reporting is probably well beyond what is required, unless the client is another financial institution looking for a benchmark. The Association does not support the requirement to forbid reuse for own account. Governance requirements may prevent conflicts of interests, and it may also be necessary to describe what own account means more precisely.

For a few years now, there have been attempts at EU level to harmonise holding of financial assets in a custody chain. While it is true that by its nature the EU is rapidly confronted with cross-border issues, the ABBL has come to realise that any change in this field implies changes in the commercial and property laws of each country, a herculean task.

Recommendation 9

Relying on fixed haircuts will also have procyclical effects; the level will simply be different and will probably more protect the asset taker. The difficult task may then be to define criteria that are granular enough, which at the same time are not too complex to implement and to analyse by regulators.

Recommendation 10

If one takes the experience of EMIR in the EU, the current assumption is that contracts should be extremely standardised to be workable and that the cost and ease of access to collateral will be much higher. The issue is that some firms will have to opt for other strategies, sometimes riskier, and that at the very least the impact on the economy is not clear. The ABBL would advise not to opt for this approach until CCP usage for OTC derivatives has been largely adopted and its consequences understood.

Recommendation 11

The ABBL could not be more in line with the last recommendation.

Specific Questions

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]
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 ABBL considers that the first question to be addressed is why have these activities emerged and what risks if any do we collectively face if they become forbidden, heavily restricted or subject to such constraints that it is no longer economical to perform them anymore. It may be useful to first try to figure out if indirect regulation is not enough. Indeed, in many cases there will be a bank involved in the transactions, an entity that is

subject to reporting and risk-weighted client considerations. Furthermore, there may be risks that would be better out of the banking system. Finally, what would the economic impact be on the credit availability if the framework were applied? From the ABBL's perspective, a major unknown is the ease of access to collateral. Good collateral is already scarce, and thanks to regulation will become even scarcer in the near future. What consequences will these proposals have in the "competition" between economic actors in gaining access to credit and what will be the main business model to emerge? In other words, can we exclude that these ideas will not encourage financial institutions to be larger, more global and interconnected as a result of regulatory pressure. Who will be best placed to manage, in terms of resources, all these interconnections, have a large balance sheet enough to lend, etc …?

With regards to the phasing in of the measures, the experience of the introduction of the Basel III framework is probably a template to keep in mind. Even if there were "test periods", all institutions tried to converge as soon as possible to the final enforceable requirements. The announcement had a major effect on market participants. At a time where economies are only about to emerge from subdued or negative growth, careful planning would suggest a minimum of 5 years before the implementation of any new rules.

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 issue is not the methodology in itself which, if not robust, is satisfactory, but the levels at which these thresholds will be set and how (fixed once for all or fluctuating). One criticism relates to the period of reference: this should be based on realistic time horizons and should reflect the duration of the product. Using ten years data for a

product that has a one week or one day maturity may only aggravate the safety requirements, thus removing assets from more productive purposes.

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?

Conceptually, the factors and ideas presented appear to make sense. However, the supervisor tests as described here may be subject to arbitrary margins. It should be remembered that being anti-cyclical also means that more risks have to be taken when market circumstances are bleak. There may be room for limiting excessive risk taking in rosy markets, but that is only part of the equation. There is also the situation to consider when markets are deeply depressed and the issue may arise if it is opportune to have countercyclical measures.

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.

The Association considers that the scope is appropriate, but the question that remains is why limit the exemption to government securities only? There are other prime quality instruments that may be exempted (high quality corporate bonds, or high quality covered bonds). The ABBL considers that this approach is not likely to be prone to regulatory arbitrage, as both counterparties to the transaction will be regulated (subject to haircut) in one way or another.

Regarding the concerns addressed in question 8, it is clear that there will be an impact. The issue is to define its size and the second round effects it may trigger. In the EU financial actors have been subject to important changes in numerous areas triggered by new regulations that were sometimes pushed through the regulatory pipelines at excessive speed. All these regulations are likely to enter into force at about the same time, the consequences of which are not yet clear. Adding a new layer with new uncertainties… may add further complexity to the process.

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.

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?

The ABBL considers that if the table is taken from the Basel Committee requirements the positive element is that it would ensure a level playing field between banking actors. Nevertheless there are three caveats. First, non-bank actors have a different status, different responsibilities (notably do not fall under most guarantee schemes) or risk profile: the ratio may therefore be too high. Secondly, the categories may not be granular enough: indeed, among bonds, for example, there are different levels of quality or robustness, therefore without necessarily relying on external rating some discrimination may help these ratios be more precise. There should at least be two subcategories to cover prime quality securities/assets and a category for the rest. And thirdly in the Association’s view only non regulated entities may be subject to such requirements, many financial institutions are subject to strict regulation which may be satisfactory for supervisory purposes.

The Association also considers that correlation or anti-correlation in portfolio of assets should be taken into account; there are offsetting effects that may contribute to a better risk sensitiveness that should be introduced as well. Perhaps a two tiers system may be offered for those willing to take portfolio effects into account and those that are not.

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?

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?

Although this may turn out to be complex to set up in practice and to discriminate among transactions -- which are for which purposes (who will decide, who will control)? -- it seems a bare minimum to exclude cash-collateralised transactions from the scope when the purpose is to use them for margining at CCPs. The Association would even argue that the exemption should not only be vis-à-vis the CCP but also in case of indirect access. Not every institution is likely to become a member of a CCP, but may use a member a situation which will also require some form of margining. The exemption should extend to that level as well and ideally to clients of these indirect participants.

More generally and taking into account rules regarding the handling of margins at CCP level, at least in the EU EMIR regulation, this exemption of a mandatory haircut may extend to other high quality securities (in the same currency). There would remain "commercial" haircuts. The issue is that until the recourse to CCPs has been fully adopted it is difficult to figure out what will be the ease of access to collateral. As they aim to reduce systemic risk, policies should not develop in themselves new or alternative sources of risks.

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?

The Association is not sure it fully understands the underlying rational for the proposal; in its approach, the example presented is a succession of transactions, subject to specific contract requirements, which will translate into the application of specific haircuts at each layer. Contractually speaking doing otherwise would contradict property rights.

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.
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.

As a conclusion and to answer the above questions, the ABBL would like to raise several issues or concerns. Since switching from a commercial/risk based haircut to a mandatory one will induce a shift in attitude, are these new limits set at appropriate

level with enough granularity? An indirect consequence is that to collateralise a transaction with these haircuts, more collateral will be required, which would increase the pressure on an already scarce resource and, as economic theory teaches us, the marginal reduction in available underlyings for collateral will put the equation of offer and demand under pressure, with the risk of entering a vicious circle which will exclude some actors and may then impact the entire economy.

A second issue is that the granularity of the haircut is not appropriate, considering, for example, all bonds at the same level misses the underlying quality of the instrument. Regarding cash, the ABBL believes that since these instruments meet the highest standards of liquidity and are characterised by low volatility they should not be subject to mandatory haircuts, at least as long as they are in the same currency as the transaction.

The ABBL is also of the view that banks subject to Basel III requirements are already subject to a comprehensive regulatory and supervisory framework: adding these haircuts will create unwelcomed arbitrage situations.

All in all, at this stage, with the many uncertainties surrounding access to collateral (of decent quality) and the difficulties to assess the impact the many new regulatory measures will have, the Association would opt for a robust test phase before launching a regulation on haircuts. The dynamic of these reuse transactions is complex and they may impact the economy at large by reducing the funding sources of financial institutions which will then have to analyse and prioritise which project to pursue and where to allocate their resources. Concretely, only changes at the global level may shift market stakeholders but as long as the dust of post-regulatory implementation has not settled it may be too soon to enter this territory.