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November 27, 2013

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Consultative Document on Strengthening Oversight and Regulation of Shadow Banking

Ladies and Gentlemen:

The Committee on Securities Lending of the Risk Management Association (the "Committee")[1] welcomes the opportunity to submit this letter to the Financial Stability Board (the "FSB") on behalf of its members, who are financial institutions that are significant participants in the agency securities lending markets.

This letter will address issues raised by the FSB's policy framework document, *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing ShadowBanking Risks in Securities Lending and Repos* which included both specific recommendations as well as additional consultative proposals (the "Consultative Document")[2]. Appendix A lists the questions that the FSB poses in the Consultative Document with specific responses as appropriate. This letter is written from the perspective of members' agency role in the securities lending markets, and thus, our comments are directed primarily towards U.S. agents involved in securities lending activities on behalf of clients located in various jurisdictions, including the U.S., Canada, Europe, the Middle East, Southeast Asia and Australia. Although the Consultative Document addresses reverse repurchase agreements ("reverse repos") in certain specific instances, our comments generally should not be taken to apply to repurchase agreement ("repo") or reverse repo activities, unless otherwise stated explicitly.

We appreciate the opportunity to comment on the Consultative Document. It is evident that the FSB has undertaken a thorough analysis of the securities lending market in both the

[1] The Committee acts as a liaison for Risk Management Association ("RMA") member institutions involved in agent lending functions within the securities lending industry, by providing products and services including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

[2] FSB, Consultative Document, *Strengthening Oversight and Regulation of Shadow Banking: PolicyFramework for Addressing Shadow Banking Risks in Securities Lending and Repos* (29 August 2013), *available at* http://www.financialstabilityboard.org/publications/r_130829b.pdf,

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Consultative Document and its previous interim report,[3] and we commend the FSB for these efforts. Effective analysis of these important issues will require significant additional dialogue with market participants, and we stand ready to assist the FSB and other authorities in these efforts. We have a manifest interest in a financial system that is more stable and less susceptible to shocks, and we look forward to continued engagement with the FSB to achieve this objective.

Before answering more specifically the questions raised in the Consultation, we would like to make some preliminary remarks:

- We believe it is important in considering possible additional regulation of securities lending and repo transactions to consider that securities lending and repo transactions are already subject to regulation at the national level in each of the major markets in which our members operate. This regulation takes the form of regulation of the underlying lender, which may be a UCITS fund, a Mutual Fund, a pension, foundation or endowment, sovereign wealth fund or insurance company assets. In addition, borrowers' activities are highly regulated and will be increasingly so, directly through such constraints as Rule 15c3-3 in the United States, or through capital or liquidity constraints through Basel III or other bank regulation. Lastly, the lending agent is also generally a regulated entity subject to oversight. In our view, those existing regulatory constraints, combined with the improvements in transparency and data collection envisaged in the consultation paper, significantly address the concerns raised by the FSB, in particular in relation to build up of excessive leverage or procyclicality.

- We are gratified to acknowledge the recognition by the FSB of the benefits that securities lending and repo transactions bring not only to lenders through the additional revenues generated by securities lending, but also to the markets in general (in terms of supporting price discovery, bringing liquidity to secondary markets or monetary financing operations for instance). Therefore, we urge that when considering additional regulations for securities lending or repos, regulators should seek to balance these benefits with the need to mitigate potential financial stability risks.

- We are also supportive of the objective for regulators to collect additional data on securities lending and repo and support the policy recommendations developed by the FSB in this area. However, we urge regulators to ensure that any reporting requirements are well calibrated and leverage existing data collection processes and market infrastructure as much as possible. We share the FSB's view that accurate data is crucial for authorities to properly monitor and fully understand the securities financing markets. In our view, regulatory initiatives aimed at improving market transparency should be the priority before deciding on specific policy recommendations.

- Given the global nature of the securities lending and repo markets and the current focus by regulators in multiple jurisdictions, we recommend an internationally coordinated approach to standards and regulation. We therefore very much welcome the work done by the FSB in this area and remain committed to assist the FSB throughout the next phase of its analysis and policy making.

In addition to the comments made in this letter, we would also like to state our agreement with and support for the comments separately submitted by the International Securities Lending Association (ISLA), the International Capital Market Association (ICMA), and the Canadian Securities Lending Association (CASLA).

Conclusion

We thank the FSB for the opportunity to comment on the Consultative Document, and to contribute to the ongoing dialogue about regulatory reform. We look forward to additional dialogue with the FSB and other authorities, and believe, as the FSB does, that healthy and robust collaboration between market participants and regulators is and continues to be an essential prerequisite for achieving effective and efficient reform. As the FSB considers our

[3] FSB, Consultative Document: *A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (18 November 2012), *available at:* http://www.financialstabilityboard.org/publications/r_121118b.pdf

comments, and those of other market participants, we reiterate our view that the development of effective recommendations requires thorough consideration of the interactions between recommended changes and the existing regulatory framework, including the significant pending changes still in the process of implementation. We submit that only through such a holistic approach can the FSB make recommendations that will enhance the overall stability of our financial system, while still preserving the important economic and liquidity benefits that agency securities lending activities provide.

Sincerely,

Fran Garrit

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The Risk Management Association

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Appendix A

Proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions.

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 believe that the role that haircuts, and specifically adjustments to haircuts, played in amplifying the last crisis is debatable and thus question the effectiveness of minimum haircuts in reducing procyclicality. A number of existing regulatory developments (such as Basel III, AIFMD in Europe) include provisions designed to limit build-up of excessive leverage directly and therefore reduce procyclicality. As a principle we believe it is far more effective and more appropriate to regulate leverage and liquidity directly than indirectly by imposing minimum haircuts.

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

As noted above, we believe that regulators should develop and implement transparency measures and analyze the data to be gathered, before finalizing and implementing additional rules on haircuts. Although the second QIS should be more comprehensive than the first we are concerned about implementing new and untested rules in this area before regulators have had the benefit of reviewing more comprehensive data on the secured finance markets. Once new regulations are agreed, authorities should allow sufficient time for firms to adapt systems and develop methodologies which may be different to those in use today or required by other regulation (such as Basel III), and assess counterparties in terms of the scope of the proposals (for numerical floors).

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]

Although we assume that the FSB does not intend for the proposals to result in haircuts for Treasury repo or for typical agent-lender securities lending transactions to be treated as financing transactions, and therefore entitle the borrower to a haircut, we believe the proposals could be interpreted in this manner. We have therefore asked for clarification on this point in our response to Q5 and Q9. However, if our assumption is not correct the financing costs for governments and for banks would increase and the securities finance markets would shrink, resulting in severe impacts on market liquidity.

Certain other regulatory initiatives, including those under Basel III, are generally increasing the costs associated with the provision of liquidity and market making through repo and securities lending. If haircut policy adds significantly to these costs a likely consequence would be that secured financing and lending activity would migrate away from the prudentially regulated sector. Notwithstanding policymakers' objectives to regulate the non-prudentially regulated sector we believe that the task of developing transparency and a harmonized framework for the regulation of these markets will be made significantly more difficult if banks are effectively prevented from acting as intermediaries.

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.

Please see our answer to Q2 above. As noted we believe that regulators should develop transparency measures and then, with the benefit of data and information, consider the implementation of policy

measures for haircuts. In addition we believe that policy in this area should not be implemented earlier than corresponding measures for non-centrally cleared OTC derivatives and Basel III.

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 the minimum standards proposed capture the important factors that could be included in a "best practices" methodology for setting and adjusting haircuts. We would also add counterparty creditworthiness to the factors to be considered. However, because the purpose of obtaining collateral is to use it to purchase replacement securities in the case of a lending transaction (or return cash in the case of a repurchase transaction), the correlation between the securities lent and those held as collateral is of prime importance and we believe there should be the greatest emphasis on such correlation, in addition to the other factors described. Given the policy focus on reducing procyclicality risk, we believe there would be great benefit achieved by mandating more frequent (i.e., daily) mark to market procedures to avoid sudden swings in collateral due to less frequent mark-to-market procedures.

A concern we have with the proposal is that it does not specifically describe to which side of a transaction the haircuts should be applied. Taken literally, it could disrupt current market practice by suggesting that parties who have traditionally been over-collaterized, i.e., securities lenders or cash receivers on lending transactions, should be under-collateralized. To address this issue we believe that any final proposals should clarify that the lender in a securities loan transaction or the cash provider in a repo transaction are the parties that receive excess collateral.

Accordingly, we suggest that the final proposals on minimum standards should provide exemptions consistent with the exemptions from minimum haircuts, including the exemption of certain categories of transactions based on the identity of the participants, the type of collateral being used, or how the collateral is held. For example, "demand-driven" transactions should be exempted from the minimum standards in line with such recommended exemption from minimum haircuts. Also, the entity that will be required to apply the proposed minimum standards should be the same entity that would receive the excess collateral under the proposed minimum haircuts requirements.

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?

Yes, the considerations generally capture all important factors that should be taken into account. In addition, the creditworthiness of the counterparty is another factor that is and should be considered. Although we support that there is a focus on the use of reliable prices, some portfolios may include both tradable and non-tradable assets; therefore there may need to be a reliance on internal pricing models for those assets. We also support the suggested regular hypothetical portfolio exercises, which will facilitate transparency for regulators into market practice and also allow them to identify any outlier firms.

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?

The RMA requests that the FSB clarify the definition of an entity subject to regulation of capital and liquidity/maturity transformation. For example, it would be helpful to clarify whether entities subject to extensive leverage and liquidity restrictions, such as UCITs, US registered investment companies, and insurance companies would be covered under this definition.

Q8. Should the scope of application be expanded (for example, to include securities financing transactions backed by government securities), and if so why?

The RMA supports the FSB's proposal that transactions backed by government securities be excluded from the proposed framework of numerical haircut floors because of the unique role the markets in these securities have with respect to the implementation of monetary and other important governmental and central bank policy initiatives. However, the RMA requests that the FSB clarify the definition of government securities. For example, it would be helpful to clarify whether securities issued by agencies of governments (such as Ginnie Mae securities) would be covered under this definition, as well as local, state, provincial or equivalent governmental issuers, in light of the similar unique role of the markets in these securities for advancing important governmental policy initiatives .

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?

The RMA supports the FSB's recommendation that there should be a carve-out for cash collateralized transactions that are demand-driven. As described further on page 2, demand-driven cash collateralized securities lending provide critical benefits to the market. In particular, these transactions are a crucial means of supplying liquidity to the equities markets. In the global securities lending market, approximately 79% of all transactions in U.S. securities, and approximately 49% of all transactions in European securities, are collateralised with cash.[4] Further, many lenders are subject to regulations that make cash one of the few forms of eligible collateral that such lenders may accept in connection with their demand-driven securities lending activities.

The RMA supports an approach for determining whether a securities loan is demand-driven that could be practically implemented and consistent with existing market practices and regulatory schemes. While the FSB proposes to focus exclusively on the nature of the investment by the lender of the cash collateral, the RMA believes that a loan should also be considered demand-driven if a borrower intends to use the borrowed securities for a specific purpose.

The borrower's purpose in engaging in a securities loan is just as relevant for determining whether a loan is demand driven as how the lender invests the cash collateral. Therefore, the RMA proposes that a cash collateralized securities lending transaction would be deemed to be demand-driven if either (a) the borrower intends to use the securities to satisfy an existing or anticipated need of the borrower for those specific securities, such as to deliver to settle short sales or to meet obligations to obtain possession or control of securities for its customers, or (b) the lender reinvests the cash collateral into a separate reinvestment fund and/or account subject to regulations (or regulatory guidance) meeting the minimum standards in the lender's jurisdiction to limit liquidity risks from such cash reinvestment activities. The RMA's suggested approach could be practically implemented by the borrower or lender in the securities lending transaction relying upon a representation by the other party as to their intended use of the borrowed securities or cash collateral, respectively. The Lender representation, (b) above, could be made at the inception of a Lender program via the lending agent (based upon Lender representations in their common agreement) either as part of the contracting arrangements or using automated messaging between agent lenders and borrowers regarding loans that already exist in the major established markets.

This suggested approach would be consistent with the regulatory approach in the U.S., which focuses on the permitted use by a broker-dealer of borrowed securities (as opposed to the use of the cash by the securities lender) as the means to prevent the parties from circumventing U.S. broker-dealer regulatory minimum margin requirements. For example, under Regulation T of the Federal Reserve Board, a U.S. registered broker-dealer may generally engage in securities borrow transactions solely for a permitted

[4] This information is based upon the RMA quarterly composite survey of its membership as of Q3 2013

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purpose (i.e. for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar circumstances"). Because of this permitted purpose regulatory requirement, securities lending transactions in the U.S. are predominantly demand driven by broker-dealers as opposed to being driven by a lender's desire to finance itself or engage in highly leveraged cash funding transactions. Borrower demand for specific securities also serves as a limit on the amount of financing that lenders may obtain.

The RMA believes that a lender could achieve the same effect as the regulatory requirement described above by receiving a representation from the borrower that the borrower intends to use the securities for a specific purpose.

Furthermore, while the RMA also supports the approach of exempting cash-collateralised securities lending transactions from the proposed framework if the lender of the securities reinvests the cash collateral into a separate account or reinvestment fund, there could be some practical difficulties in implementing this exemption for agent lenders and borrowers. In practice, borrowers rarely have visibility into the cash reinvestment strategy of lenders. Additionally, although agent lenders or their affiliates typically invest cash collateral on behalf of lenders in agency lending programs in the manner outlined in the proposed exemption, there may be less common situations where lenders choose to invest cash collateral without the involvement of the agent lender. In those situations, once the cash collateral is transferred to the lender, the agent would have no control over or direct visibility to the lender's investment strategy. Because of this potential lack of visibility by agent lenders and borrowers, the RMA recommends that agent lenders and borrowers should be able to rely upon practical solutions such as representations about the lender's intended use of the cash collateral as the basis for determining a securities loan is demand-driven. As mentioned earlier, this representation could either be contained in the contracts between the lending agent and the borrower, or could be communicated through existing automated disclosure mechanisms by which lending agents communicate the characteristics of each loan to borrowers on a daily basis (Agent Lender Disclosure, or ALD).

The RMA also seeks confirmation regarding the application of the proposed numerical haircut floors to cash-collateralised securities lending transactions which are determined to be non-compliant with the proposed exemption for cash collateralised transactions. Table 1 seems to imply the proposed numerical haircut floors should be applied to the securities, as opposed to being applied to the cash collateral. We think further clarification on this point would be helpful for the market.

Q14. Do you think cash-collateralized securities borrowing transactions where the cash is used by the securities lender to meet margin requirements of a CCP should also be exempted from the proposed framework of numerical haircut floors?

The RMA supports exempting from the proposed framework of numerical haircut floors cash-collateralized securities borrowing transactions where the cash is used by the securities lender to meet margin requirements of a CCP.

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.

Please see our answer to Q16 below.

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 RMA seeks confirmation that a collateral upgrade trade refers to a situation in which an entity that is NOT subject to regulation of capital and liquidity/maturity transformation receives securities that attract

lower haircuts (i.e. "higher relative quality collateral") than the securities received by an entity that is subject to such regulations (i.e. "lower relative quality collateral"). The RMA believes these are the types of transactions that are more likely to involve an unregulated entity receiving financing from a regulated firm. These transactions could also be representative of vanilla securities lending transactions where the lender simply requires high quality collateral. Additionally, the RMA believes that the FSB should clarify that if the unregulated entity receives lower relative quality collateral, then the proposed numerical floors would not apply because these transactions would not be expected to be a means by which an unregulated entity receives financing from a regulated firm.

The RMA supports exempting collateral upgrade transactions from numerical haircut floors when the unregulated entity does not re-use the securities it receives. The market for such transactions would likely be dramatically reduced without such an exemption. However, we respectfully request that the FSB clarify that the existence of regulatory regimes or contractual protections that permit the re-use of collateral, such as would be the case in jurisdictions where the secured party takes collateral under a transfer-of-title legal structure, as is the case in the U.K. and much of Europe, should not automatically disqualify these transactions from the collateral upgrade exemption so long as the unregulated entity does not in fact re-use the securities it receives to obtain financing.

Furthermore, similar to cash collateralized securities lending transactions, the RMA also believes collateral upgrade transactions should be exempt from the numerical haircut floors if the financial party subject to regulation of capital and liquidity/maturity transformation has a need to use the lower relative quality securities it receives, such as to settle anticipated delivery obligations or obtain possession or control of securities for its customers. This would clarify that ordinary course demand-driven securities lending transactions that are over-collateralized with higher relative quality securities, such as U.S. Treasuries, would be exempt from the numerical haircut floors.