



December 15, 2014

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

Re: Regulatory Framework for haircuts on non-centrally cleared securities financing transactions, Annex 4: Proposed application of numerical haircut floors to non-bank-to-non-bank transactions (for public consultation), October 14, 2014

Ladies and Gentlemen:

Better Markets¹ appreciates the opportunity to comment on the above-captioned consultative documents (the “Consultative Document” of the Financial Stability Board (“FSB”).

INTRODUCTION

In March 2010, the Committee on the Global Financial Systems (“CGFS”) released a report on “The role of margin requirements and haircuts in procyclicality.”² The report outlines policy options in the areas of collateral valuation capacity, through-the-cycle haircuts and capital charges, and implementation of countercyclical add-ons. The following year the Financial Stability Board (“FSB”) presented its recommendations on strengthening the oversight and regulation of shadow banking.³ As part of the recommendations, the FSB established a work-stream on the regulation of securities lending and repos. The work-stream was tasked to examine securities lending and repurchase agreements including possible measures on margins and haircuts. On April 27, 2012 the group released an interim report “Securities Lending and Repos: Market Overview and Financial Stability

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

² Committee on the Global Financial System, *The role of margin requirements and haircuts in procyclicality* (March 2010)

³ Financial Stability Board, *Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board* (27 October 2011)

Issues”⁴ that outlined seven issues arising from securities lending and repo: lack of transparency, procyclicality of system leverage/interconnectedness, collateral re-use, fire-sale of collateral assets, agent lender practices, collateral reinvestment, and insufficient rigor in collateral valuation and management practices. The group undertook the analysis by dividing the securities financing market into four segments:

- Securities lending segment: comprising the lending of securities by institutional investors (e.g. insurance companies, pension funds, investment funds) to banks and broker-dealers.
- Leveraged investment fund financing and securities borrowing segment: comprising the financing of leveraged investment funds by banks and broker-dealers.
- Inter-dealer segment: comprising transactions among banks and broker-dealers.
- Repo-financing segment: comprising repo transactions primarily by banks and broker-dealers to borrow cash from “cash-rich” entities, including central banks, retail banks, money market funds, securities lenders and non-financial corporations.

On August 29, 2013, the FSB published a policy framework for addressing shadow banking risks in securities lending and repos⁵. The framework document proposed improvements in shadow banking data, standards for collateral valuation and management, and for collateral reinvestment and re-hypothecation, as well as improvements in central clearing and bankruptcy law treatment.

The Consultative document of October 14, 2014 effectively introduces a fifth segment of the securities financing market:

- Securities financing transactions between non-banks

“The regulatory framework for haircuts on non-centrally cleared securities financing transactions is intended to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage.”⁶ The Consultative document proposes that the scope of numerical haircut floors be limited to those non-centrally cleared securities financing transactions where the primary motive is to provide financing, rather than to borrow or lend specific securities. Cash-collateralized securities lending transactions are exempted from the framework when:

⁴ Financial Stability Board, *Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report of the FSB Workstream on Securities Lending and Repos* (27 April 2012)

⁵ Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (29 August 2013)

⁶ Consultative Document, page 4.

1. Securities are lent at long maturities and the lender of securities reinvests or employs the cash at the same or shorter maturity, therefore not giving rise to material maturity or liquidity mismatch.
2. Securities are lent at call or at short maturities (which give rise to liquidity risk) only if the lender of the securities reinvests the cash collateral into a reinvestment fund or account subject to regulations or regulatory guidance meeting the minimum standards for reinvestment of cash collateral by securities lenders.

The FSB proposed three approaches to application of numerical haircut floors to non-bank-to-non bank transactions:

1. Entity-based regulation, which would rely on the existing regulatory arrangements for non-banks;
2. Product-based (market) regulations targeted at the activity of providing securities financing to non-banks;
3. Hybrid approach that combines entity-based and product-based regulations.

The FSB has invited comment on the application of the framework of numerical haircut floors to non-bank-to-non-bank transactions as well as the proposed approaches for applying the framework as outlined in the Consultative document.

SUMMARY OF COMMENTS

The theoretical approach set forth in the proposed framework for numerical haircut floors is sound. However, the theoretical appeal of the framework does not easily translate into efficient and effective implementation. In particular, details of how non-centrally cleared securities financing transactions will be separated into “financing” and “lending” categories must be an integral part of the framework. Identified below are the details of the approaches that the framework needs to include to ensure its effective implementation. Further, the comment letter offers the alternative pyramid (hybrid) approach for implementation of the numerical haircut floors in the non-bank space. This approach would have five steps:

Step 1: transactions are financing unless exempt as lending

Step 2: set out consistent international definitions of categories of financing transaction

Step 3: provide national classification of financing transactions within the international categories

Step 4: apply product-based regulation of national classification of financing transactions

Step 5: implement entity-based record keeping and reporting and other requirements for compliance with product-based regulation

The concept of a "material threshold" is a poor tool when consolidation and aggregation approaches are unknown and should not be used in the international framework. If the objective of the threshold proposal is to reduce the compliance burden for small financial participants, it can be achieved more effectively in step 5 of the pyramid framework by defining the compliance requirements tailored for small participants (ensuring that it is tightly defined so as not to create a loophole)

COMMENTS

1. Details of how non-centrally cleared securities financing transactions will be separated into "financing" and "lending" categories must be an integral part of the framework

The framework of numerical haircut floors is intended to apply to transactions where the primary motive, which should be reflected in the actual economics and terms of the deal, is to provide financing, rather than to borrow or lend specific securities. The FSB proposes two exceptions for cash-collateralized securities lending:

- first, when lending and reinvesting does not produce maturity and liquidity mismatch; and
- second, when reinvestment is undertaken into a directly or indirectly regulated reinvestment fund or account.

It is sound policy to regulate banking-like activities when they are performed by non-banking institutions. It is prudent to implement policies that facilitate an even-playing field and that do not create an unintended consequence of incentivizing a shift in banking-like operations from the traditional banking sector to unregulated areas of the capital markets. However, to implement this policy measure, the financial regulators must have a method to distinguish and thus separate "primary motives to provide financing" from the motives to borrow or lend securities.

Managing Director of Spitalfields Advisors, Mark Faulkner explained that the ex-post reasons for borrowing securities can be grouped into three categories:

"(1) borrowing to cover a short position (settlement coverage, naked shorting, market making, arbitrage trading); (2) borrowing as part of a financing transaction motivated by the desire to lend cash; and (3) borrowing to transfer ownership temporarily to the advantage of both lender and borrower (tax arbitrage, dividend reinvestment plan arbitrage)."⁷

However, ex-ante the identification of the motivation for the borrowing presents a serious challenge:

⁷ Fabozzi F, Mann S *Securities Finance, Securities Lending and Repurchase Agreements*, page 21.

“Borrowers, when acting as principals, have no obligation to tell lenders or their agents why they are borrowing securities. In fact they may well not know themselves as they may be on-lending the securities to proprietary traders or hedge funds that do not share their trading strategies openly. Some prime brokers are deliberately vague when borrowing securities as they wish to protect their underlying hedge fund customer’s strategy and motivation.”⁸

Consequently, to achieve the objective specified by the FSB of only applying the haircut floors to securities financing transactions (rather than to borrowing or lending securities), national authorities effectively have two choices. One would be to adopt a formal approach for the identification, categorization, and validation of the nature of securities financing transactions (the “formal approach”). Alternatively, they could adopt a system of universal coverage with specified exemptions, which in turn will have to be defined and validated (the “exemption approach”).

The formal approach will have to be jurisdiction based due to differences in the national securities lending markets. This will require the development and implementation of a system to categorize and evaluate particular type of contracts as either primary financing or primary lending/borrowing. It will also require a corresponding system of record keeping and reporting for lenders and borrowers to ensure a robust, fact based reason for the separation. Under the exemption approach, transactions will be subject to the haircut floors unless participants can establish they satisfy a specific exemption, with a similar requirement for factual records that validate the exemption.

From the standpoint of practical implementation of the regime in a short time-frame, the exemption approach is more feasible because it relies on internal systems of compliance and due diligence, underpinned by external regulatory validation. The regulatory validation should be supported by rigorous reporting and recordkeeping requirements to ensure that regulators can meaningfully analyze the reported data. Although narrow exemptions will need to be tightly defined, this approach is also likely to be more robust than the alternative of developing new tailored criteria for the motivation and separation of activities which may be particularly vulnerable to ambiguity, challenge, and arbitrage (as noted by Faulkner above⁹). Moreover, the exemption approach to the application of numerical haircut floors would be the most efficient way to curtail the embedded incentives for regulatory arbitrage.

However, regardless of the approach chosen by the regulatory community, the details of the approach for either separation of contracts or for exemptions must be an integral element of the framework and the proposal when finalized. Until regulators have a clear understanding of how to implement and validate the requirements for ‘in-scope’¹⁰ transactions, it will not be possible to evaluate the effectiveness of the framework or to

⁸ *Id.*

⁹ *Id.*

¹⁰ Non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided between entities other than banks and broker-dealers (e.i. non-bank-to-non-bank transactions)

assess the risk of regulatory arbitrage and maintenance of a level playing field. The FSB must develop and outline the details of methods to implement the framework to be able to evaluate the effectiveness of the proposals. Moreover, market participants will need clear guidance as to what is or is not in-scope as well as be informed of the necessary detailed record keeping for supervision and enforcement.

2. **A pyramid (hybrid) approach can be a more effective way to implement the numerical haircut floors in the non-bank space**

The FSB outlines two general channels to implement numerical haircut floors in non-bank-to-non-bank transactions:

- Entity-based approach.
- Product-based approach.

There are challenges with both approaches.

A. Entity-based approach may facilitate regulatory arbitrage

The entity-based approach is the dominant approach in current financial regulatory models. It is usually characterized by registration requirements for a specified set of market participants and a number of regulatory requirements that those participants must follow. As the FSB noted,¹¹ categories of regulated non-bank entities such as insurance companies, pension funds, and collective investment schemes would be subject to the proposals through existing regulatory arrangements. Yet, the challenge with the entity-based approach is in the consistent application of numerical haircut floors on a global level. The reasons for that are, first, the regulatory coverage of non-bank entities is not complete and, second, the categorization and regulations of regulated non-bank entities differ significantly from jurisdiction to jurisdiction.

This approach also raises a fundamental question of what is the ultimate objective of this regulation and whether the entity focus is the best way to achieve the objective. Professor Krug in her article “Escaping entity-centrism in financial services regulation” noted

“...the propensity of regulation to focus on discrete entities within an enterprise may run counter to regulatory efficiency. **The fragmentation that arises from regulatory fixation on the entity may obscure the nature of relationships between entities**, including possible conflict of interest that may arise by virtue of those relationships.”¹²

The unintended consequence of the entity based regulation of securities financing transactions may be the facilitation of regulatory arbitrage through two channels:

¹¹ Consultative Document, page 28.

¹² Krug A *Escaping entity-centrism in financial services regulation*, Columbia Law Review, Vol. 113 No. 8 (December 2013) page 2056.

1. Inter-divisional regulatory arbitrage that would take place in an enterprise where different entities/subsidiaries are subject to different regulatory regimes. For example, in the US with the introduction of bank holding company supervision there is an enterprise level oversight for all lines of business for those selected entities, yet outside of this regulatory perimeter narrow entity based regulation is still widespread.
 2. Cross-border regulatory arbitrage where different types of business are classified differently in various jurisdictions and are subject to different regulatory requirements.
- B. Effectiveness of the product-based regulation depends on how products are categorized and how quickly, thoroughly and effectively regulators respond to financial innovation

The FSB notes that “product-based or market regulation would provide the widest coverage of entities and ensures **consistency of implementation within a given jurisdiction.**”¹³ Consequently, the product-based approach likely presents the same cross-border regulatory arbitrage challenges that the entity-based approach exhibits. Moreover, even within a given jurisdiction, a permanent classification of products subject and not subject to numerical haircut floors would be necessary.

As emphasized above, without details of how non-centrally cleared securities financing transactions will be separated into “financing” and “lending” categories, it is hard to conclude whether the framework in general and application approaches in particular will achieve the stated objective. The exemption approach to the application of numerical haircut floors appears to be the best way to curtail the embedded incentives for regulatory arbitrage. That is, rather than the FSB proposed framework of identifying “in-scope transactions,” the alternative of exempting “out-of-scope transactions” could be a more promising and robust approach to pursue to achieve the stated objectives, given the arbitrage incentives.

- C. A pyramid (hybrid) approach provides a cohesive international framework while leveraging national regulatory tools

The effectiveness of securities financing transactions regulation in the non-bank area depends on international consistency of the regulatory outcomes. Given varying national regulatory regimes, entity types and product definitions, such consistency cannot likely be achieved via application of pure entity-based or product-based approaches. At the same time, an unspecified hybrid approach will not deliver the desired outcome if clear and robust agreements on objectives and definitions are not made at an early stage in advance of application. To utilize the existing regulatory tool-kit available to national authorities, while accommodating the structural coherence of the international numerical haircut floors framework, the following ‘pyramid’ (hybrid) approach may be best to achieve the desired outcomes.

¹³ Consultative Document, page 28.

The objective of the pyramid approach is a consistent outcome in the application of numerical haircut floors to non-bank-to-non-bank transactions (both within and across jurisdictions) while allowing national authorities to employ the tools available to them under either entity-based or product-based approaches. The basis of the pyramid approach is its reliance on the universal application of numerical haircut floors to non-bank-to-non-bank transactions unless an explicit exemption is available. Specific exemptions can be provided either via the entity channel or product channel and can be reversed if regulators believe that an exemption is too expansive or unwarranted. This approach would have five steps:



Step 1: transactions are financing unless exempt as lending

Step 2: set out consistent international definitions of categories of financing transaction

Step 3: provide national classification of financing transactions within the international categories

Step 4: apply product-based regulation of national classification of financing transactions

Step 5: implement entity-based record keeping and reporting and other requirements for compliance with product-based regulation

The advantage of this approach is that it provides for a top level consistent categorization at the international level that addresses the risk of cross-border arbitrage while providing local flexibility for classification of domestically available products.

This approach also provides certainty to the market that any securities financing transaction is subject to numerical haircut floors unless it is specifically exempt. Those exemptions would provide regulators with a dynamic tool to react to financial innovation taking place in the market while also being able to rely on empirical data to evaluate the effectiveness of existing exemptions. In turn, market participants will be motivated to establish robust record keeping and reporting regimes for securities financing transactions because the data would underlie the eligibility for gaining the exemption.

In addition, enhanced transparency in the market should facilitate market discipline and create an incentive system for participants not to look for loopholes in the framework, but rather to establish robust internal risk management systems that support the validation of exemption requests (assuming there is an effective supervision and enforcement program backing up the approach). For financial regulators it will provide for an evolving supervision and enforcement system that provides reliable data on

transactions and the market and establishes a track record of which exemptions worked or not and why.

D. Material threshold is a poor tool when consolidation and aggregation approaches are unknown and should not be used in the international framework

Application of financial thresholds on an international level is problematic due to varying definitions and methods of measurement of financial participants and financial products.

As the FSB noted “there are no harmonized international standards specifically in relation to securities financing activities.”¹⁴ That makes the implementation of quantitative threshold difficult if not impossible. From the standpoint of application of such a threshold, one challenge is to define to whom the threshold is applied. The application of a threshold, in turn, depends on a particular entity. To determine the “size” of relevant transactions, the regulators will need to outline the precise consolidation rules for the entity and its subsidiaries and affiliates. If the threshold is put on a purely trade level, that would facilitate and incentivize the proliferation of various special purpose entities and will undermine the objective of the regulation, as was seen in the years before the 2008 crash.

In light of different consolidation rules around the world, this is not a promising approach for the implementation of a consistent numerical haircut floors framework. If the objective of the threshold proposal is to reduce the compliance burden for small financial participants, it can be achieved more effectively in step 5 of the pyramid framework by defining the compliance requirements tailored for small participants (ensuring that it is tightly defined so as not to create a loophole).

¹⁴ Consultative Document, page 28.

CONCLUSION

The proposed framework of numerical haircut floors to non-bank-to-non-bank transactions is a good first step to limit the build-up of excessive leverage outside the banking system and to help reduce procyclicality of that leverage. However the FSB must undertake further work and provide additional details to ensure that the framework is implementable and effective. In particular, details of how non-centrally cleared securities financing transactions will be separated into “financing” and “lending” categories must be the part of the framework. Because both entity-based and product-based approaches may facilitate regulatory arbitrage, the pyramid (hybrid) approach of implementation based on application of floors unless specifically exempted should be considered. Furthermore, material threshold is a poor tool to address the issue of compliance burden for small firms when consolidation and aggregation approaches are unknown and should be avoided in international frameworks.

We hope these comments are helpful.

Sincerely,



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