IRSG

INTERNATIONAL REGULATORY STRATEGY GROUP

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FSB's Integrated Recommendations to Strengthen Oversight and Regulation of Shadow Banking

The International Regulatory Strategy Group (IRSG)[1] welcomes the opportunity to comment on the FSB's public consultation on its initial integrated set of recommendation to strengthen oversight and regulation of shadow banking.

In particular, we welcome the recognition by the FSB that shadow banking products and structures make a positive contribution to the financial system by enhancing liquidity and providing alternative sources of funding, increasing capital efficiency, distributing risk and encouraging growth. It is therefore important that any regulatory measures aimed at strengthening financial stability are targeted and proportionate to the risk posed, while preserving the benefits such activities bring to the economy as a whole.

We share concerns that inconsistent reporting to regulators hinders the appropriate regulation and supervision of "shadow banking activities" and support the FSB's objectives to mitigate the potential systemic risks associated with shadow banking.

It is also clear that one of the central issues of the shadow banking debate is one of definition and in the first place, the definition of what exactly constitutes "shadow banking". In order to be effective, policy development will need to define clearly the entities and activities in scope. The framework developed by WS3 which defines shadow banking by the economic function rather than the legal entity is a positive step towards ensuring a level-playing field between the broad spectrum of actors in this area.

In this context, we agree with, and would encourage the FSB to reinforce, its acknowledgement that in cases where a financial services holding company is subject to consolidated supervision, many of the policy tools from the FSB proposal would already be in place for the entire group, for example through consolidated capital requirements and Basel standards. This would include coverage of those parts of the group which operate in jurisdictions where local regulation does not require a banking license for specific types of activity. In these instances, recognizing the coverage of adequate consolidated supervision

[1] The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It is an advisory body to the City of London Corporation and TheCityUK. It aims to be one of the leading cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments.

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over financial services holding companies and reinforcing the adequacy of such coverage to local jurisdictions would help to avoid duplicative layers of regulation that could result in extra costs and increase the faultlines from diverging international implementation that the FSB was set up to overcome.

The IRSG would also highlight the work currently being undertaken by the EU and other jurisdictions in this area and would like to emphasize the need for a global approach in order to produce a good regulatory outcome. Problems are often presented by dual regulation, whether at an EU and/or global level. Additionally, regulating different products and/or activities in the same way may in itself create systemic risk.

In our view, it is important to put in place a targeted regulatory approach to shadow banking with the objective of introducing appropriate oversight and regulation to support financial stability while not inhibiting shadow banking's positive contribution to financial stability, saving, investment and economic growth.

The IRSG is supportive of the FSB's five general principles for regulatory measures and the supporting recommendations. Below are more detailed comments on some of the recommendations.

Money Market Funds

The IRSG broadly welcomes the recommendations put forward by IOSCO and endorsed by the FSB to increase MMFs resilience in the event of a run, in particular recommendations 6-9 on liquidity management. MMFs play an important role in our economy, providing benefits to both investors and borrowers. While we support additional reform, before undertaking structural reforms, the goals should be clearly identified and agreed upon. We therefore question whether a mandatory move to VNAV (promoted by IOSCO Recommendation 10) is necessary if all the other recommendations are put in place. Indeed, we continue to maintain that the potential risks posed by CNAV MMFs should not be overestimated in terms of European systemic risk. We can evidence the continuing strong demand for CNAV funds from institutional investors. We fear that by denying institutional investors the characteristics they seek in CNAV MMFs, IOSCO's proposed policy may drive investors away from MMFs altogether. From a regulatory point of view this could lead to an increase of systemic risk in the banking sector as corporate treasurers and other institutional investors, denied the diversification benefits of MMFs, concentrate overnight deposits in a limited number of banks perceived to be creditworthy.

We believe that a better way of addressing any perceived vulnerabilities of CNAV MMFS would be to introduce additional safeguards to reinforce their resilience and ability to face significant redemptions, which can occur in times of severe market stress when the solvency of banks is questioned, given that MMF invest primarily in bank credit.

In terms of IOSCO Recommendation 4, we believe that the CESR's *Guidelines Concerning Eligible Assets for Investment by UCITS* could provide a helpful model. These state that if a UCITS uses an amortization method, it must ensure that this will not result in a material discrepancy between the value of the money market instrument (MMI) and the value calculated according to the amortization method. The following UCITS/MMI will usually comply with the latter principles:

- MMI with a residual maturity of less than three months and with no specific sensitivity to market parameters, including credit risk; or

- UCITS investing solely in high-quality instruments with as a general rule a maturity or residual maturity of at most 397 days or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days.

Such principles - along with adequate procedures defined by the UCITS itself - should avoid the situation where discrepancies between the value of the MMI and the value calculated according to the amortization method would become material, whether at the individual MMI or at the UCITS level.

Again, conversely, we also fear that any restriction of amortisation to assets with too low a residual maturity (30 or 60 days) would considerably hurt the short term financing of the economy – and in particular, the issue of commercial paper which is usually 90 days or longer at issuance. Again, this would require issuing corporations to reduce their financing horizon to 60 or 30 days in lock-step.

Securitisation

The IRSG welcomes IOSCO's final report on the Global Securitization Market and the recommendations around risk-retention, enhanced disclosure and standardisation. We all recognize the importance of the securitisation market to providing financing to the wider economy. The industry has also been active in this area in order to restore confidence in securitisation. That said, we would like to emphasize that in order for these measures to be successful, the regulatory framework as a whole needs to provide the correct incentives and we note that EU regulations such as CRD4 and Solvency 2 threaten to undermine such efforts.

Securities lending and repo

Greater disclosure for securities lending and repo is an important positive step forward. However, we are concerned that unduly restricting this activity, which would reduce collateral velocity, at a time when regulatory measures are increasing the demand for collateral could lead to higher cost of capital and reduce the availability of financing to the wider economy.

More specifically, we agree that regulators should obtain additional information regarding the securities lending and repo markets on a non-public basis:

- Position- or exposure-based reporting should be preferred to the transaction-based reporting suggested in the Proposals. This would leverage reporting mechanisms which already exist and reflect the way that the industry already evaluates the markets and simplify regulators' analysis of collateral and collateralisation. It would also not require that regulators build a data matching and cleansing process.

- We question whether the benefits of providing transparency to the markets would outweigh the potential negative impacts, including signalling credit concerns or providing a "free" short sale signal for hedge funds.

- We agree that there should be a set of "best practices" for fund disclosures and fund investors should be provided with consistent information regarding the investment activities of their funds. However, we believe that fund-level disclosure should be proportionate to the materiality of the transactions or exposures being disclosed and we believe the extensive data suggested in the Proposal would be inappropriate in any circumstance of which we are aware.

- We agree that there should be "best practices" for collateral management and valuation, and that there should be a mandatory minimum of 100% collateralisation based on a daily mark-to-market process.

- We disagree, however with mandatory minimum haircuts above a floor of 100% and believe that haircuts, like other risk-control decisions, should be left to investors and their agents.

- We agree that there should be "best practices" for cash collateral reinvestment and that those standards should apply to all lenders, with the flexibility as described in the Proposals.

- We agree that there should be reasonable restrictions on re-hypothecation and an appropriate level of disclosure to impacted clients, but care needs to be taken to distinguish the right of re-hypothecation of pledged collateral from the right of use of collateral received through a true sale in repo or securities lending.

Again, we would point to recent guidelines developed by ESMA as a helpful example of how this issue can be addressed within the fund management industry (see *Final Guidelines on ETFs and other UCITS issues* and *Final Guidelines on repurchase and reverse repurchase agreements* issued by ESMA in July and December 2012 respectively and due to come into force in February 2013).

The principal guideline for securities lending[2] is that a "UCITS should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending arrangement into which it has entered". Concerns were raised at the time that application of this rule — that any securities lent by the fund should be immediately recallable — to reverse repo arrangements would rule out the entering into of "term" repo and reverse repo arrangements by funds, and that is why ESMA consulted further on the issue.

The final guidelines on repo and reverse repo[3] therefore state that:

- For reverse repo arrangements, a fund should ensure that it is able "at any time" either to recall the full amount of cash or to terminate the reverse repo agreement. The cash may be recalled either on an accrued basis (typically only applicable to overnight arrangements) or on a mark-to-market (i.e. cost of unwinding the transaction) basis. If the cash is recallable at any time on a mark-to-market basis, the fund should value the reverse repo on a mark-to-market basis as well.
- For repo agreements, the fund should ensure that it is able "at any time" either to recall the securities subject to the arrangements or to terminate the repo agreement.
- Fixed term reverse repos and repos that do not exceed seven days are considered as arrangements which allow the assets to be recalled at any time.

[2] http://www.esma.europa.eu/content/Guidelines-ETFs-and-other-UCITS-issues
[3] http://www.esma.europa.eu/system/files/2012-722.pdf

The European Commission has also proposed to look at both issues as part of its UCITS 6 package.[4]

The IRSG hopes that you will find our comments useful and looks forward to strengthened and targeted oversight and regulation of the shadow banking sector to support investor confidence and economic growth.

[4] http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf