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14 January 2013

Via e-mail to [fsb@bis.org](mailto:fsb@bis.org)

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002, Basel, Switzerland

Re: Comment on Consultative Document on Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

Ladies and Gentlemen:

The Global Financial Markets Association (“GFMA”)<sup>1</sup> appreciates the opportunity to comment on the Financial Stability Board (the “FSB”) Consultative Document on *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (the “Consultative Document”), published November 18, 2012. The Consultative Document was preceded by an April 27, 2012 interim report from the FSB’s Workstream on Securities Lending and Repos, titled “*Securities Lending and Repos: Market Overview and Financial Stability Issues.*”<sup>2</sup>

The Consultative Document proposes thirteen policy recommendations on securities lending and repos (the “Proposed Recommendations”) to address perceived financial stability risks. GFMA supports the goal of reducing risks to financial stability but believes that it is important to carefully tailor any policy initiatives so that they further this goal without unnecessarily undermining the securities lending and repo markets, which play several crucial roles in the financial system.<sup>3</sup> In this letter, we discuss each Proposed Recommendation (“PR”) with attention to (i) its connection to risks to financial stability and (ii) its potential effects on the

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<sup>1</sup> The Global Financial Markets Association (GFMA) brings together three of the world’s leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit <http://www.gfma.org>.

<sup>2</sup> SIFMA commented on this interim report in a letter dated May 25, 2012.

<sup>3</sup> As stated in the Consultative Document:

Securities lending and repo markets play crucial roles in supporting price discovery and secondary market liquidity for a variety of securities issued by both public and private agents. They are central to financial intermediaries’ abilities to make markets, and facilitate the implementation of various investment, risk management, and collateral management strategies. Repo markets are also instrumental in monetary refinancing operations in many jurisdictions. (p.2)

crucial securities lending and repo markets. Given timing constraints, this letter should be viewed as a high-level response to the Proposed Recommendations, on which we would be happy to expand in a continuing dialogue with the FSB.

## **A. Transparency**

### **PR 1-3: Increasing Information Available to Regulatory Authorities.**

The first three Proposed Recommendations are intended to increase the information about securities lending and repo activities available to regulatory authorities so that they can detect the risk that:

- *The failure of a large institution could destabilise one or more of its counterparties and possibly the broader markets in which it is active;*
- *A large financial institution could suffer a liquidity shortage during a period of market stress due to an excessively short maturity profile of its financing; or*
- *Sudden changes in behavior by participants in securities lending and repo markets, triggered for example by the failure of a large institution, could destabilize one or more financial institutions that are particularly active in that market. For example:*
  - *A sudden increase in repo haircuts could create a liquidity shortage for firms that rely heavily on this market for funding; and*
  - *The sudden request to return cash collateral posted against borrowed securities could lead to large losses and fire sales if the instruments in which cash collateral has been invested become illiquid. (Consultative Document, pp. 4-5.)*

Specifically, the Consultative Document includes the following three Proposed Recommendations:

*[Proposed] Recommendation 1: Authorities should collect more granular data on securities lending and repo exposures amongst large international financial institutions with high urgency. Such efforts should to the maximum possible extent leverage existing international initiatives such as the FSB Data Gaps Group, taking into account the enhancements suggested by the Workstream.*

*[Proposed] Recommendation 2: Trade repositories (TRs) are likely to be the most effective way to collect comprehensive repo and securities lending market data. The FSB should consult on the appropriate geographical and product scope of such TRs. The FSB should encourage national/regional authorities to undertake feasibility studies for the establishment of TRs for individual repo and securities lending markets, as well as coordinate and facilitate those efforts. Depending on the consultation findings on the appropriate geographical and product scope of TRs, the FSB should also establish a working group to identify the appropriate scope and undertake a feasibility study for one*

*or more TRs at a global level. Such feasibility studies should involve market participants.*

*[Proposed] Recommendation 3: As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such market-wide surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.*

The Consultative Document also includes suggested fields for transaction-level data (which could be collected by a trade repository), firm-level data (which could be collected through an official survey or regulatory reporting where transaction-level data is not collected), and aggregate data (which could be published on a regular basis, by aggregating trade-level data).<sup>4</sup> (Consultative Document, pp. 5-7.)

GFMA agrees that it is important for regulatory authorities to be able to access the information they need to monitor system-wide risks. We believe, however, that further investigation and analysis should be undertaken before recommending the collection of specific data or the methodology (*e.g.*, trade repositories) for collecting that data. Specifically, adequate consideration must be given to: *first*, understanding each national or regional securities lending or repo market, the ways in which the financial stability risks identified in the Consultative Document are manifested in that market, and how market data would be used by that market's regulators to respond to those risks; *second*, determining what data is necessary to detect and respond to those risks and what data is already available to the relevant regulatory authorities; and *third*, evaluating what and how additional data about activity in such market should be collected to enable regulatory authorities to detect and respond to these risks, with due attention to the burden that the collection and analysis of the data would place on the vital securities lending and repo markets and on the limited resources of the regulatory authorities. Rather than recommending at this time the collection of specific information, or specific methods (*e.g.*, trade repositories) for collecting that information, we believe the FSB should recommend that each national or regional regulatory authority take the following three steps, in order:

Step 1: Work with market participants to develop and implement a survey of such nation or region's securities lending and repo markets and their participants.

Step 2: Based on the results of this survey, work with market participants to understand and identify ways in which the potential risks to financial stability exist in their market, the tools the regulatory authorities have available to address these risks, the data already available to detect and address these risks, and what (if any) additional data should be collected to detect and address these risks. It is possible that a regulatory authority could conclude at this stage that the ongoing collection of comprehensive transaction data for

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<sup>4</sup> We do not consider in detail each of the data fields because, as discussed below, we believe specific data collection decisions should only be made after additional investigation and analysis by the national or regional regulators. We note, however, that many of these fields (*e.g.*, "first callable date") would need significant further specification before they could be used for data collection, some would simply not be available at the time of the trade (*e.g.*, cash reinvestment return), and others are ill-suited to many common transactions (*e.g.*, "collateral asset class" for general collateral or tri-party repo where many types of securities are eligible).

securities lending and repo activities is not the best way to detect and address the relevant risks.<sup>5</sup>

Step 3: After determining what, if any, additional data should be collected, work with market participants to determine what methods would be appropriate to make that additional data available to the regulatory authorities.

Following this process will lead to the collection of data that is most useful to the regulatory authorities in detecting and addressing risks to financial stability, without unduly burdening the vital securities lending and repo markets, and without consuming unnecessary quantities of regulatory resources.

In carrying out this investigation and analysis, the national or regional regulators should consult with one another (through the FSB or otherwise) to avoid conflicting or overlapping reporting requirements and to take advantage of economies of scale by harmonizing their requirements and cooperating where possible in data collection. For example, this investigation and analysis may result in regulatory authorities in multiple jurisdictions concluding that the collection of transaction data through trade repositories would be most useful to them in detecting and addressing risks to financial stability. In that case, uniform reporting to transnational trade repositories (rather than inconsistent reporting to separate trade repositories for each jurisdiction) could be more efficient for market participants and regulators while reducing inconsistency and jurisdictional uncertainty. (GFMA does not object in principle to the collection of comprehensive transaction data, or the use of trade repositories for the collection of that data, as contemplated by PR 1-3, if that is determined to be the right information and best collection method after the investigation and analysis we recommend.)

While GFMA agrees that it is important to financial stability for regulatory authorities to obtain the data they need to detect and address systemic risk, it does not necessarily follow that public disclosure of this data also contributes to financial stability.<sup>6</sup> Since the Consultative Document proposes to recommend the collection of data that includes many proprietary, competitively sensitive, and/or confidential elements, regulatory authorities should maintain the confidentiality of this information unless it can be established that its disclosure is necessary to support financial stability (and the protective effect cannot be obtained through other less burdensome means).

#### **PR 4: Expanded Corporate Disclosures**

The Consultative Document notes that, although global financial institutions publicly disclose information about their activity and exposures in the securities lending and repo

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<sup>5</sup> We note that the risks of the securities lending and repo markets identified in the Consultative Document can generally be categorized as either credit risk or liquidity risk and addressing (and potentially reporting on) those risks more comprehensively may be superior to addressing securities lending and repo market participation separately from other sources of such risks.

<sup>6</sup> If it were shown that public disclosure regarding securities lending and repo market activity would materially enhance financial stability, we would be happy to participate in discussions of the appropriate scope and form of such public disclosure. We believe publication of market data should not be instituted until after the benefits from the disclosure are weighed against the potential impact on the functioning of these vital markets.

markets in their regulatory filings and audited financial statements, this information “falls well short of what regulators would ideally need in order to monitor the build-up of systemic risk in normal times and track its transmission between firms during a stress event.” The Consultative Document proposes:

*[Proposed] Recommendation 4: The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions’ securities lending, repo and wider collateral management activities as needed, taking into consideration the items noted above.*

Specific items suggested by the Consultative Document for consideration by the accounting standard-setting bodies include: a “sources and uses of securities collateral” statement and qualitative information (generally separately provided for repo, reverse repo, securities lent and securities borrowed) regarding things such as counterparty concentration, maturity breakdown, composition of securities, collateral margins, percentage of collateral reused, proprietary and customer activity, amount of indemnification of securities lending clients, and size of credit exposures.

As stated above, GFMA strongly supports making available to regulators the information they need to detect and address systemic risk and we have suggested a process for regulators to determine what information about the securities lending and repo markets they need and the appropriate method for obtaining that information. We think it is unlikely that the best way to provide regulators with all needed information about the firm’s participation in the securities lending and repo markets will prove to be public disclosure through a firm’s public financial statements and reports. Financial statements and reports are designed to provide financial information to investors, lenders and other creditors that is useful in making decisions about providing resources to the reporting entity, rather than to provide the information regulators need for market supervision.<sup>7</sup> Financial statement information is therefore provided in a different manner and at a different level of abstraction than we believe regulators would use to detect and address system risk. Since the information relevant to detecting and addressing systemic risk may include proprietary, competitively sensitive and/or confidential elements, it should be provided to the regulators on a confidential basis, rather than disclosed publicly.

GFMA also supports robust corporate disclosure of financial information to investors, lenders and other creditors through financial statements and reports. It is not obvious to us that including additional detail in public financial reports regarding a reporting entity’s participation in the securities lending and repo markets would further financial stability or the objectives of financial reporting. We would, however, be happy to participate together with the FSB in discussions with the accounting standard-setting organizations, including the IASB and FASB, to determine whether any additional standards would be appropriate in this area. We note that these standard-setting organizations currently have a number of projects reviewing the

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<sup>7</sup> International Accounting Standards Board (“IASB”) Conceptual Framework for Financial Reporting 2010 (Sept. 2010) [OB2, OB10] and the Financial Accounting Standards Board (“FASB”); FASB, Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting (Sept. 2010) [OB2, OB10].

treatment of securities lending and repo transactions within their overall financial reporting framework.<sup>8</sup>

## **B. Haircuts**

### **PR 6: Minimum Standards for Collateral Haircut Methodologies**

*[Proposed] Recommendation 6: Regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral haircuts. Those guidelines should seek to minimise the extent to which these methodologies are procyclical. Standard setters (e.g. BCBS) should review existing regulatory requirements for the calculation of collateral haircuts in line with this recommendation.*

The Consultative Document recommends that regulators introduce minimum standards for the methodologies that firms use to calculate collateral haircuts in order to limit their procyclical effects – *i.e.*, to reduce the speed and extent to which haircuts are reduced in good times (increasing leverage) and increased in bad times (decreasing leverage). The fundamental recommendation is that haircuts be set to cover, at a high level of confidence (*i.e.*, at least 95%), the maximum expected decline in the market price over a conservative liquidation horizon,<sup>9</sup> calculated using data that includes at least one stress period.<sup>10</sup> The Consultative Document also recommends that the haircut methodology take into account other risk considerations, such as the risk of liquidating large concentrated positions and correlations between collateral value and counterparty default.

Although the haircut methodologies generally used by our member firms would satisfy this proposed standard, GFMA believes that any new standards for haircut methodologies should allow firms a high degree of flexibility in their application. Any new haircut methodology standards should be considered in the context of the full scope of regulations already applicable to the haircuts applied by market participants to ensure that the combined effects of the multiple standards do not unduly burden the vital securities lending and repo markets and reduce liquidity at a time when increased liquidity and collateral requirements are being imposed in order to enhance financial stability. Information collected in Step 1 of the process we recommend above in our comments on PR 1-3 should inform this analysis and the calibration of any standards set with respect to haircuts so that any such standards are closely tailored to the goal of limiting risks to financial stability. Many participants in the securities lending and repo markets are (or will shortly become) subject to standards for their haircuts or haircut methodologies or that otherwise control leverage and limit procyclical effects of their haircuts. To the extent these market participants also become subject to new haircut methodology requirements established pursuant to this recommendation, those new requirements

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<sup>8</sup> *E.g.*, Current FASB Project: Transfers and Servicing: Repurchase Agreements and Similar Transactions; IASB continues work on IFRS 9 Financial Instruments.

<sup>9</sup> For consistency with Basel III, this “conservative liquidation horizon” should not exceed five business days for most asset classes.

<sup>10</sup> Any recommendation that includes the term “stress period” should provide a clear definition so that it can be applied uniformly in jurisdictions accepting the recommendation.

should be harmonized with the other standards applicable to those market participants or should contain sufficient flexibility for market participants to apply the new standards in a way that is consistent with the other requirements applicable to their haircuts. In addition, because securities loans and repos generally involve bilateral exposures (e.g., the repo seller risks the loss of the haircut in a failure by the repo buyer), any standards for haircut methodologies should allow parties the flexibility to take into account their relative credit risks (and also portfolio and transaction structure) as well as the risk in the change in value of the subject securities. For this reason, haircuts are the most successful in reducing risk when they are bilateral and credit driven.

GFMA also believes that haircut methodology standards should be developed globally and applied by all relevant regulators. If some markets or market participants are subject to less stringent standards and, as a result, can offer more favorable terms, firms in need of financing would naturally tend to seek financing from the participants offering more favorable terms as the result of more relaxed haircut methodology standards. This “race to the bottom” disadvantages market participants who are subject to the more stringent requirements and undermines the goals of the more stringent requirements by reducing the extent of the securities lending and repo business that is subject to the more stringent requirements – there is no reduction in procyclicality if the effect of new haircut methodology standard is to drive the business to market participants that are not subject to them.

#### **PR 7: Numerical Floors on Haircut**

*[Proposed] Recommendation 7: In principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets. The FSB should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives. This would include consultation on the levels and the scope of application of such framework by counterparty, collateral, and transaction type.*

The Consultative Document suggests consultation on whether a framework of numerical floors on haircuts would be effective and workable in achieving policy goals of restricting leverage and limiting procyclicality. GFMA generally believes that numerical floors would be counterproductive. Haircut levels should be a business decision based on a firm-specific risk assessment (in accordance with any appropriate haircut methodology standards) of the particular transaction in the context of the firm’s relationship with the counterparty. Regulatory floors on haircuts would decrease the flexibility of market participants to provide credit at a level that is appropriate to the transaction in the context of the counterpart relationship and thus will tend to distort markets. These distortions could increase procyclicality rather than reduce it.

Moreover, to establish numerical floors, it is necessary to categorize transactions or assets, with the inevitable result that the floors are either inappropriately high or inappropriately low for some transactions or assets within the category. Any schedule of numerical floors will also be unable to properly account for the risk-increasing effects of concentrated positions or the risk-reducing effect of hedges or diversification. Where a numerical floor is higher than it should be, it will reduce liquidity and increase the chance of a

“fire sale” in times of stress. Where a floor is inappropriately low, it will embolden less sophisticated parties to take on more risk and potentially create a “race to the bottom” as firms come under competitive pressure to move toward the numerical floor. Where firms adopt the numerical floor as their haircut requirements, there will also be a movement toward financing the assets in each category that are relatively risky since these are the ones where the haircuts are likely to be the most inappropriately low (or at least less excessive if the haircut for the entire category is inappropriately high).

In the course of its discussion of numerical floors, the Consultative Document recognizes that there is a distinction between securities financing transactions where the primary motive is financing and formally similar transactions where the primary motive is to lend/borrow specific securities. It recommends that the numerical floors should not apply to transactions where the primary motive is to lend or borrow securities. While GFMA does not endorse the promulgation of numerical floors for any securities financing transactions for the reasons outlined above, we agree strongly that, if numerical floors are promulgated, they should not apply to transactions where the primary motive is to lend or borrow securities. This exclusion would prevent numerical floors from adversely impacting the proper functioning of securities lending and related markets where the building up of excessive leverage is not a significant concern.<sup>11</sup> We also recommend that regulatory authorities considering the introduction of haircut methodology standards in response to PR 6 should be cognizant of this important distinction and assure that any standards they promulgate either do not cover transactions where the primary motive is to lend or borrow securities (rather than financing) or cover these transactions in a flexible manner consistent with the proper functioning of the securities lending and related markets.

## **C. Cash Collateral Reinvestment**

### **PR 8: Minimum Standards for Cash Collateral Reinvestment**

*[Proposed] Recommendation 8: Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.*

GFMA joins the Committee on Securities Lending of the Risk Management Association (the “RMA Committee”) in its support for certain of the proposed minimum standards for cash collateral reinvestment, described in their comment letter dated January 14, 2013, but also shares the RMA Committee’s concerns about certain other proposed standards that reflect a “one size fits all” approach that is inappropriate to the securities lending and repo context. For example, cash collateral reinvestment guidelines should be consistent with lenders’ stated investment objectives and securities lenders and repo counterparties should stress test their

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<sup>11</sup> If numerical floors on haircuts are promulgated, then other markets should also be reviewed to determine whether they should similarly be excluded from the scope of the numerical haircuts. For example, any numerical floors should also exclude from their scope interbank repo transactions on sovereign collateral. Because we believe it is a mistake to promulgate numerical haircut floors as a general matter, we have not cataloged the markets where there are additional, market-specific reasons not to set numerical haircut floors.



ability to meet calls for the return of cash collateral. As discussed in the RMA Committee's letter, however, certain of the proposed standards may impede the ability of market participants to provide financing tailored to clients' and counterparties' specific risk tolerances and may have other unintended consequences.

## **D. Rehypothecation**

### **PR 9-10: Regulations Regarding Rehypothecation of Client Assets**

In PR 9-10, the Consultative Document proposes principles for client asset re-hypothecation<sup>12</sup>:

*[Proposed] Recommendation 9: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:*

- *Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;*
- *In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and*
- *Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.*

*[Proposed] Recommendation 10: An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation.*

GFMA is generally in agreement with these Proposed Recommendations, but we think it is important to make it clear that:

- The "client assets" subject to restriction on re-hypothecation are solely non-cash assets that, at the time of re-use, were carried by the intermediary in the client's brokerage or custodial account, and therefore do not include (i) assets that, prior to the re-use, were transferred to the intermediary and not carried for the client by the intermediary in a brokerage or custodial capacity or (ii) assets transferred by the client in (or as security for) counterparty transactions (such as securities loans, repos or derivatives) and not carried for the client by the intermediary in a brokerage or custodial capacity.

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<sup>12</sup> For this purpose, the Consultative Document defines "re-hypothecation" as the use of client securities delivered in one transaction in order to collateralize another transaction.

- In order to determine whether the client assets are used “for the purpose of financing client long positions and covering short positions” it is not actually necessary to trace the use of proceeds; instead, one way an intermediary can demonstrate compliance with this limitation is by ensuring the aggregate net proceeds of all re-hypothecations of client assets does not exceed the aggregate net resources used in the facilitation of all client transactions; and
- The third bullet of PR 9 would be satisfied in circumstances where the entity conducting the re-hypothecation of client assets, or its parent or an affiliated entity that has agreed to be responsible for the return of such assets, is subject to prudential regulation.

## E. Collateral Valuation

### PR 11: Minimum standards for Collateral Valuation and Management

*[Proposed] Recommendation 11: Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.*

The Consultative Document recommends the following “minimum regulatory standards” for implementation by regulatory authorities:

1. *Securities lending and repo market participants (and, where applicable, their agents) should only take collateral types that they are able following a counterparty failure to: (i) hold outright without breaching laws or regulations; (ii) value; (iii) risk manage; and (iv) liquidate in an orderly way.*
2. *Securities lending and repo market participants (and, where applicable, their agents) should have contingency plans for the failure of their largest market counterparties, including in times of market stress. These plans should include how they would manage the collateral following default.*
3. *Collateral and lent securities should be marked to market at least daily and variation margin collected at least daily where amounts exceed a minimum acceptable threshold.*

GFMA is in general agreement with these standards, which are generally consistent with standards and practices currently applied by sophisticated participants in the securities lending and repo markets. We think, however, that if the FSB adopts these recommendations, it should make it clear that:

- In order to be able to “hold [an asset] outright without breaching laws or regulations” following a counterparty failure, it is not necessary that a collateral taker (including a repo buyer) be able to invest directly in that asset in the ordinary course; it is only

necessary that the laws and regulations applicable to the collateral taker permit it to own the asset following a counterparty failure;<sup>13</sup>

- A collateral taker is able to “liquidate [an asset] in an orderly way” following a counterparty failure if the collateral taker has a reasonable basis for believing that it will be able to liquidate the asset within the “conservative liquidation horizon” used to evaluate the haircut applicable to the asset<sup>14</sup> (and, to the extent the collateral taker believes that a discounted price would be required in order to effect a liquidation within such horizon, such discount was incorporated into the haircut or applied when the asset was marked-to-market);
- Any regulations implementing the contingency plan requirement should provide additional information about the required level of detail and allow each market participant the flexibility necessary to create a plan appropriate to its role in the market (*e.g.*, a hedge fund and a bank may have different types of plans), the level and nature of its participation in the market (*e.g.*, a dealer running a large repo book would need a different plan than a corporation that occasionally invests relatively small amounts of idle cash in triparty repo), and the resolution regime applicable to the relevant counterparties; and
- For securities that are not frequently traded and are valued based on an analysis of the security and its issuer rather than on reported trading price, a daily mark-to-market does not require the market participants to re-underwrite the security each day, so long as the market price is revised whenever there is any relevant change in economic inputs (*e.g.*, material changes in interest rates would change the value of illiquid fixed-rate debt) and reanalyzed when there is material new information about the security or its issuer.

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<sup>13</sup> For example, a legal or regulatory requirement that a collateral taker promptly liquidate certain types of assets if it comes to own them as a result of a counterparty failure does not mean that the collateral taker is unable to own those asset outright following a counterparty failure, it just requires the collateral taker to take certain actions if it does come to own those assets.

Any other interpretation of this restriction could be contrary to the intent of the creators of the relevant legal or regulatory scheme. If a collateral taker is not permitted by applicable law or regulation to invest in an asset in the ordinary course, but is permitted to provide financing against that asset and own it (however temporarily) if a counterparty failure forces the collateral taker to realize on its security, that reflects a judgment by the creator of the legal or regulatory scheme about the proper role of the collateral taker in the relevant market. For example, U.S. banks are not permitted to invest directly in residential real estate in the ordinary course, but are significant lenders against residential real estate collateral and are permitted to take title to residential real estate in foreclosure prior to disposition. 12 U.S.C. § 29

<sup>14</sup> See PR 6.

## F. Structural Aspects of the Securities Financing Markets

### PR 12: Central Clearing

*[Proposed] Recommendation 12: Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.*

Although the Consultative Document recommends that regulators consider the costs and benefits of introducing CCPs into their securities lending and repo markets, it is skeptical about the case for the expansion of CCPs beyond inter-dealer repo on safe collateral (*i.e.*, government securities) – where CCPs already have a significant market share because of the strong incentives (*e.g.*, balance sheet netting) that make additional regulatory incentives unnecessary. Although CCPs can reduce credit exposures through multilateral netting, improve regulator’s access to market data about the segments of the market that are cleared,<sup>15</sup> and bring more robust collateral and default management processes, the Consultative Document recognizes that these benefits cannot be achieved in all markets and market segments. Outside the inter-dealer market, it is unusual for a party to have offsetting repo and reverse repo, or securities borrow and loan transactions that could be netted,<sup>16</sup> so central clearing does not have the potential to reduce credit exposures or interconnectedness. And, as the Consultative Document recognizes, the use of CCPs can lead to moral hazard problems because market participants have less incentive to manage collateral risk if the trades are centrally cleared and the central clearing of repos on less liquid securities is practically difficult because the CCP may not be able to properly value and manage the collateral.<sup>17</sup> GFMA would support an analysis of the expanded use of CCPs in the securities lending and repo markets, but shares the Consultative Document’s skepticism about the expansion of CCPs into areas of the securities lending and repo markets where they are not already thriving.<sup>18</sup>

### PR 13: Changes to Insolvency Law Treatment

*[Proposed] Recommendation 13: Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.*

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<sup>15</sup> Of course, this is not a reason for having a CCP. If the data is important, it can be as easily provided to a trade repository as submitted to a CCP.

<sup>16</sup> Indeed, in the United States, running a matched book of repos or securities loans may cause an entity to become a securities “dealer” required to be registered and regulated as such.

<sup>17</sup> To the extent this is correct, a CCP may actually increase risk. And, since that risk is also concentrated in the CCP, it can become more likely to be a threat to financial stability.

<sup>18</sup> GFMA also notes that any recommendation to expand the use of CCPs beyond overnight or very short term repo transactions should recognize that, because CCPs generally reserve the flexibility to change haircuts during the term of the transaction, a cleared term repo does not necessarily provide the repo seller with the same assured liquidity as a non-cleared term repo.

GFMA opposes any proposal to narrow the insolvency law “safe harbors” for securities lending and repo transactions. These safe harbors are essential to the functioning of the securities lending and repo markets and crucial roles those markets play in supporting price discovery and secondary market liquidity for the securities markets.

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Thank you again for the opportunity to provide our views on the Consultative Document. We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis. If you have any questions, please do not hesitate to contact Robert Toomey (+1 212 313-1124, [rttoomey@sifma.org](mailto:rttoomey@sifma.org)) or Sidika Ulker (+44 20 7743 9305, [sidika.ulker@afme.eu](mailto:sidika.ulker@afme.eu)).

Yours sincerely,

A handwritten signature in black ink, appearing to read "Simon Lewis". The signature is written in a cursive style with a large initial 'S' and a long horizontal stroke at the end.

Simon Lewis  
CEO, GFMA