Frankfurt am Main,
15 December 2014

BVI's response to the FSB's consultation on the proposed application of numerical haircut floors to non-bank-to-non-bank transactions dated 14 October 2014

BVI[1] appreciates the opportunity to comment on the proposed application of numerical haircuts on collateral to securities financing transactions between two non-bank counterparties.

General remarks

We welcome the clarification as to the objectives of the FSB's work in the preface to the consultation paper. There, the FSB depicts that the initiative at hand is meant to address risks to financial stability emerging outside the regular banking system "while not inhibiting sustainable non-bank financing models that do not pose such risks". Moreover, the FSB clarifies that "the approach is designed to be proportionate to financial stability risks, focusing on those activities that are material to the system, using as a starting point those that were a source of problems during the crisis".

Securities financing activities by European investment funds cannot give rise to material stability risks due to the already existing regulation on securities lending and repos. There is a whole array of regulatory measures in place aiming at mitigating potential risks from securities financing transactions by European investment funds. In particular, we would like to point out the following:

Standards for re-investment or re-use of collateral

In Germany investment funds have been bound by demanding standards on cash collateral reinvestment since nearly two decades. Similar standards have been introduced by ESMA for all European UCITS in 2012. Under the relevant ESMA Guidelines, cash collateral received from securities lending can be either placed on deposits, invested in high-quality government bonds, used for reverse repo transactions with regulated credit institutions or invested in short-term MMFs[2]. These restrictions on cash-collateral reinvestment effectively eliminate the risk of maturity and liquidity transformation. Similarly, due to the requirement for non-cash collateral not to be sold, re-invested or pledged and to be held by the UCITS depositary in case of title transfer[3], re-hypothecation of assets received as collateral is generally excluded. The new ESMA Guidelines for UCITS also mitigate the risk of improper valuation of collateral by providing for valuation on at least a daily basis and making the acceptance of collateral displaying high price volatility more difficult[4].

Possibility to create leverage

European regulated retail funds such as UCITS cannot use securities financing transaction to access leverage on the fund portfolios. In the securities lending market, UCITS are only allowed to act as

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members manage assets in excess of EUR 2.2 trillion in retail funds, Spezialfonds and assets outside investment funds. As such, BVI is committed to improving the overall conditions for investors, while at the same time promoting a level playing field for all investors across all financial markets. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. (BVI's ID number in the EU Transparency Register is 96816064173-47). For more information, please visit www.bvi.de.
[2] Cf. Para 43 j) of the ESMA Guidelines on ETFs and other UCITS issues dated 17 December 2012 (ESMA/2012/832).
[3] Para. 43 g) and i) of the ESMA Guidelines on ETFs and other UCITS issues.
[4] Para. 43 b) of the ESMA Guidelines on ETFs and other UCITS issues.

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lenders of securities with the corresponding counterparty risk being subject to strict collateralisation requirements under the ESMA Guidelines. The acceptable collateral must be highly liquid, valued on at least a daily basis, of high credit quality and sufficiently diversified[5]. Moreover, as explained above, non-cash collateral received by UCITS cannot be sold, re-invested or pledged and should be held by the depositary in case of a title transfer. Cash collateral may only be reinvested in high-quality government bonds or short-term MMFs[6]. ESMA applies these restrictions also to the treatment of any proceeds from repos and reverse repos such as the purchase price which basically eliminates any risk of leverage associated with these transactions (cf. our further explanation below)[7].

Maturity and liquidity transformation

Pursuant to the ESMA Guidelines, UCITS must be at any time able to terminate securities lending and repo transactions and to recall securities subject to such transactions[8]. Fixed-term repo transactions are only allowed for a period not exceeding seven days[9]. Under these circumstances, UCITS' engagements in securities financing entail no relevant risk of maturity transformation. Furthermore, it should be taken into account that any collateral received by UCITS in the course of securities financing operations must be highly liquid and traded on a regulated market or a multilateral trading facility with transparent pricing allowing for quick disposition at a price which is close to pre-sale valuation[10]. This provision basically eliminates the risk of liquidity transformation when lending out or concluding repos over liquid assets in exchange for collateral.

Limitations of counterparty risk

Under the German law, securities lending to one counterparty is limited on a gross basis to 10% of the fund's NAV. Transactions with several counterparties belonging to the same corporate group are all counted towards the same limit[11]. According to the ESMA Guidelines applicable to all UCITS, the combined counterparty risk exposure in relation to OTC derivative transactions, securities lending and repos must not exceed 10% in case the counterparty is a credit institution and 5% in other cases[12]. Hence, the risk of interconnectedness of UCITS with other market participants potentially leading to a contagion in times of crisis is heavily reduced. The new ESMA Guidelines also require UCITS to put in place a clear haircut policy taking into account the characteristics of each class of assets especially in terms of credit standing or price volatility. The collateral and haircut policy must be clearly communicated in the fund prospectus[13].

To sum up, it should be clear that under the UCITS framework securities lending and repos cannot be used for building up leverage in the fund portfolios nor can be otherwise considered a relevant source of systemic risk. It is also worth mentioning that Germany and some other EU countries have extended the standards introduced by the ESMA Guidelines in terms of securities financing transactions by UCITS to the regulation of other investment funds.

[5] Cf. para. 43 of the ESMA Guidelines on ETFs and other UCITS issues.
[6] Para. 43 g), i) and j) of the ESMA Guidelines on ETFs and other UCITS issues.
[7] This objective is quite clear from para. 42 of the ESMA Guidelines on ETFs and other UCITS issues.
[8] Cf. para. 30-32 of the ESMA Guidelines on ETFs and other UCITS issues.
[9] Para. 33 of the ESMA Guidelines on ETFs and other UCITS issues.
[10] Cf. para. 43 a) of the ESMA Guidelines on ETFs and other UCITS issues.
[11] Cf. § 54 para. 1 second sentence of the German Investment Act.
[12] Cf. para. 41 of the ESMA Guidelines for ETFs and other UCITS issues with reference to Article 52(1) third subparagraph of the UCITS Directive.
[13] Para. 46 and 47 of the ESMA Guidelines on ETFs and other UCITS issues.

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Lastly, it should be noted that securities financing transactions by UCITS cannot be conducted for financing purposes as presumed in the FSB report, but have the only objective of improving the performance of the fund. This is true for both securities lending and repo agreements. In terms of the latter, it should be noted that under the ESMA Guidelines cash obtained by the fund cannot be used for general investment purposes, but may only be reinvested in high-quality government bonds or short-term MMFs[14]. This is due to the fact that any proceeds from repo transactions concluded by UCITS, including the purchase price, are treated as collateral and subjected to the same restriction on re-use and reinvestment. Notwithstanding its inconsistencies in legal and economic terms, this approach makes clear that UCITS are not allowed to use repos as an additional source of financing.

Therefore, we kindly request the FSB to grant sufficient flexibility to its members to implement the final recommendations on securities lending and repos in a manner which is proportionate to the financial stability risks inherent in the relevant market operations. In this regard, the FSB members should be able to exempt certain market players or certain activities e.g. from the requirement to apply the numerical haircut floors if the stability risk associated with their engagement in securities financing is eliminated or essentially mitigated by the relevant national/supranational framework.

In the EU context, we are convinced that such treatment should be granted for proportionality reasons to UCITS and other investment funds following the UCITS standards on securities lending and repos.

Specific comments

In relation to the questions for consultation raised by the FSB, we would like to provide the following replies:

Q1: *Do you agree that the application of the framework of numerical haircut floors as described in Section 3.3 to non-bank-to-non-bank transactions will help to reduce the risk of regulatory arbitrage and would maintain a level playing field?*

Subject to the general observations made above, we agree that the framework of numerical haircut floors should be extended to cover non-bank-to-non-bank transactions in order to avoid regulatory arbitrage and to maintain a level playing field. However, the FSB members should be given sufficient flexibility to ensure a proportionate regulatory response to the systemic risk associated with securities financing. Such proportionality measures should i.e. encompass an exception for UCITS and other investment funds subject to the UCITS rules on securities financing or equivalent standards in their relevant jurisdictions.

Q2: *In your view, how significant is the current level of non-bank-to-non-bank transactions? Do you expect that level to increase going forward and why? What types of non-bank entities are, or could be, involved in such transactions?*

The to-date experience of BVI members shows that securities financing transactions are very rarely concluded between two non-banks as counterparties. However, bearing in mind that bank-to-bank

[14] Para. 43 j) of the ESMA Guidelines on ETFs and other UCITS issues.

transactions are not affected by the FSB recommendations on numerical haircut floors, this might change in future if banks will recede their financing transactions with non-banks due to the less attractive collateral terms compared to bank-to-bank financing models.

Q3: *Do the approaches set out above cover all potential approaches in applying numerical haircut floors to non-bank-to-non-bank transactions? Are there any other approaches? If so, please describe.*
Q4: *Please provide any comments you have on the strengths and weaknesses of the approaches set out above, as well as any other approaches you believe the FSB should consider. What issues do you see affecting the effective implementation of numerical haircut floors for non-bank-to-non-bank transactions?*
Q5: *What forms of avoidance of the numerical haircut floors are most likely be employed for non-bank-to-non-bank transactions? Which of the proposed implementation approaches is likely to be most effective in preventing such avoidance?*

From BVI's perspective, a hybrid approach involving both entity-based and market regulation would be preferable. In our view, such concept should allow regulators to take into account the existing regulations which have the effect of mitigating systemic risks corresponding with securities financing transactions and where appropriate, to build upon those regulations, thus facilitating consistent evolvement of standards. Market-wide regulation could be used in order to close any gaps in relation to any market players not subject to entity-specific rules. The latter approach has been adopted by the proposed EU Regulation on securities financing transactions.

As stated above, we believe that the chosen regulatory approach should be proportionate to the potential level of systemic risk. Hence, UCITS and other investment funds that do not engage in securities lending or repos for financing purposes and are subject to rules substantially eliminating the risk of interconnectedness, maturity/liquidity transformation or leverage should not be subject to further regulation (cf. our general remarks above).

Q6: *If different entity-type regulations are used, do you see the need to ensure comparative incentives across different entity types? If so, please describe any potential mechanisms that may help ensure comparative incentives across entity types.*

We do not entirely understand what the FSB means by "comparative incentives" to be applied across different entity types. In any case, we regret that the FSB has missed the opportunity to cover bank-to-bank financing transactions within the scope of the recommendations on numerical haircut floors. As a consequence, it must be expected that secured financing provided by non-banks will become less attractive compared to bank-to-bank transactions since it will regularly involve higher collateral requirements.

Q7: *If market regulation is used, should the FSB consider setting a materiality threshold of activity below which entities do not need to register? If so, what could be an appropriate level for such a threshold?*

All BVI members are authorised fund or asset managers subject to continuous supervision. Therefore, this question is not relevant to BVI members.

Q8: *Do you see the need for a phase-in period in applying numerical haircut floors to non-bank-to-non-bank transactions, and if so how long should it be and why? Does the appropriate phase-in period very depending on which approach is followed? Should it very by jurisdiction based on the size and importance of the non-bank-to-non-bank sector or should it be consistent across jurisdictions?*

Should the consideration of numerical haircut floors become mandatory, we definitely see the need for a phase-in period in order to give market participants sufficient time for renegotiating the relevant agreements. The BVI members' experience with the implementation of the ESMA Guidelines on ETFs and other UCITS issues and the entry into force of the EMIR regime in Europe which both have influenced the regulatory requirements for haircuts has only recently exposed the practical difficulties associated with such renegotiations. These difficulties should become even harder to overcome if banking counterparties are not bound by the FSB's standards on numerical haircuts as foreseen in the report at hand. Therefore, we believe that the phase-in period should be not shorter than 24 months and should apply consistently to all market participants.

In this context, we would like once again to emphasize that UCITS and other investment funds that do not engage in securities lending or repos for financing purposes and are subject to regulation fundamentally reducing the potential for systemic risk associated with these activities should be exempted from the numerical haircut requirements for proportionality reasons.