January 11, 2013

Comments on the Financial Stability Board's Consultative Document:
A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative document: *A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, released on November 18, 2012 by the Financial Stability Board ("FSB").

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the rules proposed by the FSB.

<General Comments> (Q1 – 5)

As noted in our comment of May 25, 2012 on the Financial Stability Board's Consultative Document: *Interim Report of the FSB Workstream on Securities Lending and Repos*; in order to address the financial crisis, we are fully aware of the necessity of: (i) introducing a regulation over securities lending and repos associated with some illiquid assets and participants building-up the excessive leverage such as hedge funds that are currently not being subject to regulatory supervision, with the view to reducing leverage and procyclicality risk; and (ii) enhancing transparency of the market to such an end.

Although the consultative document considers to some extent, we respectfully request that a further thorough analysis of key issues as set out below be made to ensure a more in-depth consideration of these issues.

The first issue to note is that the types of securities lending and repos prevailing in a market differ across jurisdictions, and therefore risks to be mitigated/monitored may significantly vary across jurisdictions. In Japan, for example, given that Japanese government bonds (including inflation-indexed government bonds and floating-rate government bonds) account for 99.7% of bonds used as collateral under repos,[1] the necessity to introduce a regulation to mitigate leverage

[1] See the section "Balance of bonds used as collateral under repos" in chapter (4) "Strengthening of risk management under repos" of the BOJ Reports & Research Papers: *Development and Issues of Money Markets in Japan* issued by Bank of Japan in December 2010.

and procyclicality risk in a manner similar to transactions involving illiquid assets is considered to be significantly limited.

Further, in most cases of securities lending and repos in Japan, the transaction data is generally managed by the Pre-Settlement Matching System of the Japan Securities Depository Center, Inc. ("JASDEC"), which means that Japan already has certain processes in place to centrally manage such transaction data. Moreover, government bond repos are largely settled by the Japan Government Bond Clearing Corporation which plans to increase the number of participant banks in the near future, and hence further mitigation of systemic risk is expected. In terms of stock lending transactions, JASDEC is planning to establish a DVP (Delivery Versus Payment) clearing system, and accordingly a more advanced initiative compared to other jurisdictions is considered to be implemented in Japan. We therefore believe that it is crucial to fully take into account such existing infrastructures and frameworks in place in each jurisdiction.

In addition, given that repos using government bonds as collateral are being utilized by central banks for monetary operation purposes in major jurisdictions and play a central function in the short-term money market, it is considered that the current condition and market practice of financial markets in each jurisdiction (e.g. forms of transactions, type of securities used as collateral, central clearing initiatives, market participants and their positioning in the market) should be fully factored in, and consideration should be given to curb over-regulation, in areas such as reporting and minimum haircuts, beyond the intentional purpose of shadow banking regulation. Lack of such consideration may have an adverse effect not only on securities lending/repos markets but also on government bonds markets (both primary and secondary markets), and may also be a hurdle for the stable absorption of government bonds in every jurisdiction.

Another significant issue is the consistency with other financial regulations that have been implemented or are under consideration. The Basel III framework (the leverage ratio requirement, liquidity requirement and capital adequacy requirement), for example, already applies a tool to reduce leverage and procyclicality risk to entities subject to prudential regulation (banks etc.). These should be taken into account to ensure sufficient consistency across financial regulatory regimes and to avoid imposing overlapping regulations on specific legal entities. Our opinion therefore is that, the scope of shadow banking regulation should be focused on legal entities, limited to those not subject to the Basel III framework in order to avoid double regulation, for example excluding those legal entities subject to prudential regulation.

While the importance of enhancing market transparency is well understood, we also respectfully request the FSB to give careful consideration to avert applying excessive reporting/disclosure requirements, and ensure consistency with other disclosure requirements under the Basel Pillar 3 framework and for financial accounting purposes, including common data template based reporting to supervisors being discussed by the FSB and Enhanced Disclosure Task Force. If new disclosure/reporting requirements are to be implemented, entities should be provided with sufficient time for preparation to address such requirements, for example to develop systems.

<Specific Comments>

[Recommendation 1]

As specified in the General Comments above, in Japan, generally, JASDEC manages the transaction data of securities lending and repos. Hence, in discussing the data collection from international financial institutions, it is necessary to explore approaches that would not require financial institutions to create/construct additional data by leveraging such existing infrastructures.

[Recommendations 2 and 3]

(Q6 - 8)

While it is understood that a data collection approach by authorities need to be improved, the use of a trade repository (TR) is not considered the most effective way to do so, and therefore other alternative approaches should be discussed.

Given the current market practice of OTC derivatives, the use of a TR would impose a significant burden on financial institutions for preparation including system development because it is assumed that it would cost several hundred thousand dollars per financial institution. Annex 2 of the consultative document refers to significant upfront costs of a TR and also points out that “it may be costly to change once established.” In addition to these costs, it should be recognized that market participants need to bear running costs to use a TR. Unless the use of a TR is made completely free, if a financial institution deals with a couple of hundred securities lending/repos transactions per day, the annual cost of using a TR is expected to amount to some tens of thousands of dollars, assuming that a certain amount of fees (e.g. a few dollars per transaction) incurred on a regular basis. As for transactions using high credit-quality government bonds as collateral in a low interest rate environment, since transactions could only earn a limited profit in such an environment, such cost burden would clearly likely to be a disincentive for some legal entities depending on its size. Moreover, a lender may require an interest rate that reflects the above costs from a borrower, resulting in an increased funding cost.

In addition, taking into account actual OTC derivative transactions, if the use of a TR is made mandatory, jurisdictions which have no established relevant framework (including Japan) would need to use a TR in other jurisdictions, imposing them to address legal risk arising from documentation and information management under different laws/regulations and market practices. Authorities would also need to bear a burden of global-based data collection/matching. As such, the use of a TR is considered to be inefficient.

Our view is that there are other alternative approaches rather than using a TR that enable better information collection for both authorities and market participants, and using such approaches is more efficient at least in Japan.

In Japan, as noted in the General Comments, generally, the transaction data of securities lending and repos is managed to a certain extent by JASDEC, and authorities may leverage this infrastructure.

Examples of other potential approaches to collect securities lending and repo market data include the data provision to authorities by central counterparties (CCPs) for those transactions settled through CCPs because, to some extent, information on bonds used as collateral can be captured on a counterparty-to-counterparty basis, similarly to the case of OTC derivatives. Another approach is to use data generated from a settlement system of each financial institution for underlying securities, adding specific information to the data produced by such a system, and reporting such data to authorities on a regular basis.

In the light of the above situation, we consider that using existing infrastructures or information management frameworks is a more efficient option to collect transaction data, and that it is important to allow discretion to each jurisdiction in deciding a specific approach.

Ongoing initiatives are carried out in Japan to enhance market transparency, which include: (i) regular reporting to authorities by market participants (e.g. monthly), (ii) publication of a repo rate (issued on a daily basis; and for nine terms from T+0 up to 1 year), and positions of bond borrowing and lending transactions (issued on a monthly basis; presenting balance of bonds borrowed/loaned by business, and balance by cash collateral transaction and uncollateralised transaction, etc.) by the Japan Securities Dealers Association, and (iii) a periodic survey on the short-term money market by the Bank of Japan (to be conducted annually). A practical approach would be to utilise these initiatives and strengthen them in line with the purposes of policy recommendations which will be finalised in the near future, in order to further enhance the transparency of markets.

(Q6)

With regards to the proposed information items listed in Box 1, in the light of the above comments, local authorities should be given discretion to select necessary information from these items. In addition, the following comments are raised from practical perspectives.

As "proposed information items for enhancing transparency/disclosure in securities lending and repos," Box 1 lists information items including "(ultimate) counterparty" (transaction level data), "breakdown of counterparties and concentration" (firm-level data) and associated haircut ranges by collateral asset class. However, disclosing the name of individual counterparties may lead to specifying differences in the transaction terms and conditions of counterparties, which may create a disincentive for counterparties to execute securities lending/repos, resulting in a decline in market liquidity as well as market value of collateral assets. As such, the disclosure of the name of respective counterparties should not be required, regardless of whether as firm-level data or aggregate data. Disclosing aggregated data based on certain categories such as by type of counterparty (by financial institution and non-financial institution) requires careful consideration since such disclosure may also give rise to a concern that revealing differences in the transaction terms and conditions of counterparties may become a disincentive factor. Moreover, some jurisdictions currently may have placed a restriction on providing some of the transaction information items outside their jurisdiction, and such restriction also needs to be taken into account.

[Recommendation 4]

(Q9)

The necessity of authorities to monitor the items listed in the consultative document such as "counterparty concentration," "maturity breakdown of trades" and "composition of collateral received against securities lent" is well understood; however, as noted in the General Comments, the items to be disclosed to investors need to be consistent with Basel Pillar 3 and financial accounting disclosure requirements. In addition, a detailed disclosure of funding information may unintentionally amplify procyclicality in funding in stress periods. Given these, such information or items should not be subject to disclosure, and these should be limited to those reporting items to authorities.

It is also noted that, in discussing the "counterparty concentration" disclosure, the number of core financial institutions within a jurisdiction should be considered.

[Recommendation 5]

(Q10)

Improving reporting by fund managers to end-investors needs to be given consideration in order not to impose an excessive burden on those subject to such reporting.

In Japan, a robust regulatory regime including the Trust Business Act has been implemented to ensure that trustees pay close attention to safeguarding of assets and the certainty of recovery of principal when managing funds in transactions executed under a trust agreement such as repos of Japanese government bonds and stock lending transactions. In addition, investors are given in advance an explanation of risk-related matters based on the agreement including the selection of borrowers, and transactions are executed only after investors understand such matters. Furthermore, as mentioned in the General Comments, Japan already has a settlement system in place, and hence, in implementing reporting requirements for fund managers in each jurisdiction, we respectfully request the FSB to allow discretion in determining the reporting frequency and selection in the disclosure items.

As it is interpreted that this Recommendation is intended for disclosure to retail investors, the proposed reporting items should not include data on transactions between financial institutions or entities which are deemed as a "professional" under local laws and regulations.

[Recommendation 6]

(Q11)

The consultative document provides a description in page 11 (section 3.1.1) which can be interpreted as the FSB is considering the application of minimum haircuts to transactions using CCPs. In the case of those securities lending and repos which are settled by using a qualified CCP that meets IOSCO/CPSS Principles for Financial Market Infrastructure; the qualified CCP contributes to the reduction in counterparty risk and addresses fluctuating market prices, thereby mitigating systemic risk. Therefore, for transactions using a qualified CCP standards set by each qualified CCP should prevail and minimum haircuts should not be applied. Allowing such a difference in the minimum haircuts application is considered to increase the incentive to use qualified CCPs.

[Recommendation 7]

(Q12 – 17)

The uniform application of minimum haircuts to every repo and securities financing transaction is considered unreasonable. It is necessary to avoid regulatory overlap with the Basel III regime and other existing financial regulations as well as to fully take into account differences in financial markets across jurisdictions. Our particular concern is applying minimum haircuts to those entities subject to prudential regulation and to sovereign bonds.

The significance of introducing minimum regulatory haircuts can be understood. However, it is to be noted that, even if a minimum haircut is introduced, leverage can be increased, for example, by increasing the turnover number of repo transactions, and the effect of mitigating the build-up of excessive leverage and procylicality may be limited.

In addition to the comment above, we respectfully provide the following comments on each issue in introducing the minimum haircut framework proposed in this consultative document.

(1) Collateral type

We oppose the discussion of uniformly applying minimum haircuts to all securities lending and repos regardless of whether they are based on illiquid assets (including relatively lower-quality sovereign bonds) or based on high-quality sovereign bonds and other securities. At least sovereign bonds with high-quality should not be subject to the proposed minimum haircut requirement.

Taking a repo transaction (including those executed in the form of bond borrowing and lending) in Japan for example, its market size amounts to JPY70 to 80 trillion (or approximately US$1 trillion) on a stock basis, and its monthly trade volume amounts to JPY300 to 600 trillion (or approximately US$4 to 8 trillion) on a flow basis. As mentioned in the General Comments, most of the bonds traded in this type of transaction are Japanese government bonds, and such a repo transaction plays a fund needs/supply adjustment function as a core transaction in the short-term money market in Japan. If the proposed minimum haircut requirements are implemented, the repo market may contract due to negative factors such as increased execution costs and administrative burdens, stirring concerns over undermining the funding tool of the short-term money market, as well as over decline in liquidity in the secondary market of Japanese government bonds (which is not driven by general price fluctuations) and a rise in a yield due to regulatory factors. If the minimum haircut requirements are uniformly applied, and simply estimating its impact on liquidity by using the sovereign haircut for those with over 1 year and up to 5 years residual maturity of collateral (i.e. 2%) specified in the consultative document, the demand for additional collateral would amount to trillions of yen (or tens-of-billions of dollars), having a significant impact on liquidity. This level of impact cannot be accepted by core market participants in Japan, and therefore the uniform application of minimum haircuts should be avoided.

Under the liquidity coverage ratio (LCR) requirement of the Basel III framework, high-quality liquid asset which qualify for Level 1 Assets such as sovereign bonds are permitted to be included in the numerator of the LCR in full (100%). While the consultative document states that numerical haircut floors should apply to sovereign bond collateral subject to default risk, it is however considered that sovereign bonds exposed to such default risk in certain jurisdictions may not satisfy specific LCR conditions (e.g. proven record as a reliable source of liquidity in the markets even during stressed market conditions). In other words, it is considered that there is no reasonable basis for the application of minimum haircuts to those sovereign bonds and other securities which local authorities and financial institutions in respective jurisdictions assessed as meeting the LCR conditions, at least to the extent that such bonds satisfy the LCR conditions. From the perspective of ensuring consistency across financial regimes, sovereign bonds which satisfy the LCR conditions should also not be subject to minimum haircut application under the proposed securities lending and repos regulation. Further, bonds such as agency bonds/international agency bonds which meet the LCR conditions should be treated in a way similar to sovereign bonds, and it should be stipulated as so.

While we do not support the uniform application of the minimum haircuts to sovereign bonds and other securities, it is understood that not uniformly applying the minimum haircuts globally may invite conflict in cross-border transactions. Therefore, it is also a possible practical option to exclude from the minimum haircut application transactions which are secured by high-quality sovereign bonds and are executed in the same currency as the collateral (e.g. transactions denominated in Japanese yen secured by Japanese government bonds and transactions denominated in U.S. dollars secured by U.S. Treasury bonds) within the home country. Such treatment is consistent with the 0% risk-weight requirement under the Standardized Approach (a reduced risk weight is applicable especially to those exposures to sovereigns denominated in domestic currency and funded in that currency).

(2) Transaction type and counterparty type

According to the consultative document, the purpose of introducing minimum regulatory haircuts for repos and securities financing transactions is to limit the build-up of excessive leverage and reduce procyclicality. Entities subject to prudential regulation are required by Basel III to comply with its leverage ratio, liquidity and capital adequacy requirements which are considered to be more effective in mitigating the risk of excessive leverage and procylicality. Therefore, applying the minimum haircuts to entities subject to prudential regulation would evidently result in imposing overlapped regulations. Given this, minimum haircuts should not be applied to transactions by entities subject to prudential regulation that comply with the requirements under Basel Ⅲ framework. Hence, the scope of application of the minimum regulatory haircuts should be limited to entities which have the ability to build up excessive leverage and entities which are susceptible to procylicality.

While our opinion is to exclude securities lending and repos of entities subject to prudential regulation from the minimum haircut requirements, if some form of minimum haircut requirements is to be implemented, from the perspective of ensuring consistency across financial regimes, we support the approach proposed in the section (ii) *Counterparty typ*e in page 17 of the consultative document which allows financing of entities subject to prudential regulation to be excluded.

Additional comments on issues regarding minimum haircuts are described hereinafter.

(Q14)

Regardless of whether to take the high level approach or back-stop level approach, implementing the minimum haircut requirements to securities lending and repos would increase demand for high-quality liquid assets as collaterals including sovereign bonds. Similarly, there is also a concern that other financial regulations including the LCR requirement under Basel III and the BCBS/IOSCO's "Margin requirements for non-centrally-cleared derivatives" which is under discussion may also drive the demand for collateral. Such multi-layered effects arising from strengthened regulations may lead to a sharp decline in liquidity of collateral assets and increase in volatility at the time of financial crisis, thereby amplifying systemic risk. In conducting the quantitative impact survey (QIS) on each financial regulation, such amplification effects should be fully taken into account.

Both the high level approach and back-stop level approach are based on data which assumes a 10-business day holding period. Sovereign bonds and other securities meeting certain criteria should be scoped out of the minimum haircut requirements; however even if it is determined that these should be included in the scope, assuming a 10-business day holding period for such sovereign bonds and other securities to convert into cash is deemed as overly conservative. A holding period which reflects market liquidity of securities collateral (e.g. one business day) should be used to calculate haircuts in such cases.

There may be some conditions that actual value of securities collateral becomes lower than the value applied minimum haircut, due to fluctuations in the market price. In such cases, it is requested that entities are not obliged to pledge/receive collateral only through margin calls. It would be necessary to reduce practical burdens by allowing other approaches such as limiting the application of minimum haircuts to those transactions with specific maturity and setting a minimum transfer amount (threshold).

It should also be noted that if minimum haircuts are set at a level higher than internal model-based haircuts calculated by financial institutions, it may create a disincentive for financial institutions to maintain/improve their internal models.

(Q16)

A repo transaction can be classified into a General Collateral (GC) repo which does not specify any securities acceptable for lending and borrowing and a Special Collateral (SC) repo which specify acceptable securities. However, since such classification is not necessarily clearly defined, it is difficult for a third party to subsequently assess whether a repo is GC or SC, and hence, a transaction type reported by a trader is directly recorded into the transaction data. Given this, in discussing for finalization of the paper, we expect that the definition of relevant terms such as GC and SC, the method of subsequent assessment of a transaction type by a third party and other matters be clarified.

(Q18)

The Basel III framework (i.e. credit risk mitigation) permits netting of repo-style transactions on an aggregated basis subject to a legally enforceable agreement in calculating capital requirements for repo-style exposures. The numerical haircut floor should be applied in a way that is consistent with how the above netting rule is applied by individual entities.

[Recommendation 8]

(Q19)

We agree with Recommendation 8 which excludes banks which are subject to prudential regulation from the proposed minimum standards for cash collateral reinvestment on the basis that such treatment ensures consistency with other financial regimes.

While the proposed minimum standards for cash collateral reinvestment is basically being supported, the areas of stress tests and disclosure requirements need to further consider conditions unique to each jurisdiction, particularly the market conditions of cash collateral reinvestment, in order to determine the scope of application. Especially for stress testing, as its necessity, content and frequency differ significantly depending on each financial institution’s risk profile associated with securities lending and repos, a careful consideration should be given to avoid uniform implementation of the scope of application.

[Recommendation 9]

(Q20)

Recommendation 9 proposes that “Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets”. We agree with this as it ensures consistency with other financial regimes.

A concern however is that the re-hypothecation requirement if introduced, may create a relatively high-hurdle which may force smaller-business market participants to exit from the repo markets which are serving as a source of funding. In addition, the necessity of this requirement differs considerably depending on the credit quality of sovereign bonds and other securities in each jurisdiction. Therefore, considerations should be given to avoid the uniform application of the re-hypothecation requirement.

Further, in Japan, a trust agreement sets forth the asset segregation duty, under which re-hypothecation of trust assets or reuse of such assets for other customers is not permitted. Hence, we would like to confirm that this type of trust agreement is not subject to the re-hypothecation requirement.

[Recommendation 11]

(Q21)

Similarly to our comment on Recommendations 6 to 8, it is considered unreasonable to discuss whether to apply minimum regulatory standards for collateral valuation and management to all securities lending and repo transactions regardless of whether they are based on illiquid assets (including relatively lower-quality sovereign bonds) or based on high-quality sovereign bonds. At least transactions based on sovereign bonds with high-quality should not be subject to the proposed minimum regulatory standards.

The consultative document proposes that “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.” It is requested that the FSB explicitly define the “largest market counterparties.” Further, as the content of contingency plans to be developed is considered to vary depending on the risk profile of each financial institution's securities lending and repos, a careful consideration should be given to avoid implementing a uniform requirement for contingency plans.