Meeting Between Staff of the Federal Reserve Board
and Representatives of the Investment Company Institute
May 9, 2016

Participants: Jordan Bleicher, Sean Campbell, and Amy Lorenc (Federal Reserve Board)

Sarah Bessin, Fran Pollack-Matz (T. Rowe Price), and Jane Wagner (Vanguard)

Summary: Staff of the Federal Reserve Board met with representatives of the Investment Company Institute (ICI) to discuss implementation of the minimum margin requirements for securities financing transactions (SFTs). The ICI representatives argued that such requirements should not apply to bona fide securities lending transactions, or to SFTs in which financing is being provided to a bank or broker-dealer. Materials provided to Federal Reserve Board staff as background for the meeting are attached.

Attachments

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January 14, 2013

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

Re: Addressing Shadow Banking Risks in Securities Lending and Repos

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on the Financial Stability Board's proposed policy framework for addressing risks in securities lending and repos (the "Consultation").[2] Given the extent of their participation in these markets, U.S. registered investment companies ("registered funds") have a strong interest in the FSB's recommendations in this area.[3]

As explained in much greater detail below, we commend the FSB for seeking to identify and address systemic risk concerns in these markets, but we oppose certain recommendations in the Consultation on the grounds that the FSB's proposed regulatory standards would inappropriately intrude on areas best left to national regulators or market forces. Most notably, ICI opposes FSB recommendations that would set specific fixed or minimum numerical floors for repo haircuts, limit the types of collateral repo buyers may accept, and dictate additional disclosure by fund managers.

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.9 trillion and serve over 90 million shareholders.

[2] *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, FSB Consultative Document (November 18, 2012), which is available at https://www.financialstabilityboard.org/publications/r_121118b.pdf.

[3] Our comment letter on the interim report by the FSB's Workstream on Securities Lending and Repos ("WS5") described in more detail the extent of U.S. fund participation in the securities lending and repo markets. Our comments on the interim report can be found at https://www.financialstabilityboard.org/publications/c_120806p.pdf (the "2012 ICI Letter").

Executive Summary

We have several general comments on the Consultation, along with a number of comments on specific recommendations made by the FSB. These are summarized below and explained in greater detail in the remainder of the letter.

General Comments

- The FSB must clearly distinguish securities lending from repos in making its final recommendations. Although they are both categories of collateralized finance, securities lending and repo markets are distinct and often quite different. While some of the FSB's recommendations may apply to both markets, most should be tailored to address the unique issues presented in each context.

- While we strongly support the FSB's efforts to address systemic risks, it is critical that the FSB take a balanced approach to its recommendations. In its final report, the FSB should explicitly recognize not only the potential risks with regard to securities lending and repo financing, but also the benefits of those activities and the ways in which existing regulation or market practices in some jurisdictions already mitigate systemic risks.

- Given the differences in securities lending and repo markets around the world and differences in the extent of existing regulation, the FSB should take a less prescriptive approach with its final recommendations. In most cases, the FSB should encourage national regulators *to consider* its recommendations in light of the particular circumstances in their market, rather than directing these regulators to adopt a specific type of requirement.

Specific Comments

- We support the FSB's efforts to ensure that authorities have the information they need to effectively monitor securities lending and repo markets for systemic risks. In gathering data, authorities should: (1) request only the information they need to monitor for systemic risks in the markets; (2) gather that information in the most efficient way reasonably available; and (3) have appropriate systems and procedures in place to ensure the confidentiality and security of such information before requesting it from market participants.

- The collection of data by regulators is one area where we favor a globally harmonized approach, although the process through which regulators could gain access to consistent and comprehensive data without imposing duplicative or incompatible reporting obligations on market participants will need to be developed through further consultations with industry and a careful review of existing processes and available information.

- We generally support the public release of data on an aggregated basis to the extent such disclosure advances the goal of mitigating systemic risk. That said, the economic terms of securities lending transactions, such as fee splits, should not be publicly disclosed. It would be difficult to disclose aggregated data on these terms in a meaningful way. Even if that could be done, such disclosure is unnecessary to mitigate systemic risks.

- We oppose the FSB's recommendations with respect to corporate disclosure and fund manager disclosure. The FSB should defer to local authorities on these types of disclosure issues, which have little or no connection to systemic risk.

- The FSB's focus on repo haircuts is misplaced. It appears based on supposed pro-cyclical trends in haircuts for which there is no historical evidence, at least for tri-party repo in the United States, and disregards the fact that many buyers enter into a repo based primarily upon the seller's capacity to pay the repurchase price, rather than upon the value and liquidity of the collateral. Collateral is just one factor when deciding what form or amount of credit to extend to an institution.

- Moreover, we fundamentally disagree with any attempt to regulate the negotiated terms of market transactions such as repos, and believe that a number of problems (correctly identified and acknowledged in the Consultation) would result from the establishment of minimum numerical floors for repo haircuts, especially at the very high levels discussed in the Consultation. Accordingly, we oppose the FSB recommendations that would set specific fixed or minimum floors for repo haircuts.

- Finally, it is unnecessary for the FSB to set forth specific minimum regulatory standards on collateral valuation and management. Two of the FSB's three principles in this regard have already been implemented in the U.S. and the third has nothing to do with collateral management and is based on a faulty premise. We specifically recommend that the FSB's final recommendations on collateral management not limit repo market participants to collateral that they are able to hold outright following a counterparty failure. As set forth in the Consultation, the FSB's recommendation might be misinterpreted to restrict repo buyers only to collateral that they could have purchased outright and held indefinitely for investment, which would be inconsistent with the fundamental nature of a repo and would unduly restrict the market without lessening the risk of a "fire sale" of collateral following a counterparty default.

These comments are explained in more detail below.

The Need for a Balanced and Tailored Approach

The FSB's effort to identify and investigate potential causes of systemic risk in the global financial markets is an important policy endeavor, which we strongly support. We urge the FSB, as it contemplates new policy frameworks for the securities lending and repo markets, to take a balanced and tailored approach to its recommendations.

Securities lending and investments in repos are two of the myriad investment techniques used by U.S. registered funds to improve the return on their portfolios for the benefit of their shareholders. And although they are both categories of collateralized finance, securities lending and repo markets are distinct and often quite different, and are approached differently by registered funds. Due to strict regulatory limits, securities lending is a relatively minor strategy for most U.S. registered funds, designed to add incremental returns with minimal additional risk. Registered funds are most often beneficial owners of the securities being lent, taking and reinvesting cash collateral. Investments in repos may be a more prominent strategy for some registered funds, particularly money market funds. Funds that enter into repos do so only with high quality counterparties, and most frequently enter into repos as a collateralized short term cash investment (*i.e.*, they are the investors receiving non-cash collateral to secure the repo).[4]

In making its final recommendations, the FSB should take account of these differences and clearly distinguish securities lending from repos. While some of the FSB's recommendations may apply to both markets, most should be tailored to address the unique issues presented in each context. The FSB even may wish to consider making two separate sets of final recommendations, one for securities lending and one for repos.

It also is critical that the FSB take account of not only the potential risks of a given activity, but also the benefits of that activity and the ways in which existing regulation or market practices in some jurisdictions already have been developed to mitigate those risks. For the most part, the Consultation does not do so, perhaps because it would be impractical to attempt to highlight existing regulations or beneficial market practices in a report that covers both securities lending and repo markets across the globe. By focusing almost entirely on the potential risks in securities lending and repo markets, however, the Consultation presents an unbalanced view.[5]

The FSB should expressly recognize that, at least in some jurisdictions, existing regulatory requirements and recent market developments mitigate financial stability concerns. The FSB's recommendations are premised on the opposite assumption. In the introduction, the Consultation

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[4] The Federal Reserve Bank of New York's white paper on tri-party repo provides a comprehensive description of the repo market and the role money market funds play in it as cash investors. *See* Tri-Party Repo Infrastructure Reform (May 17, 2010), available at http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf.

[5] Indeed, the Consultation explains the benefits of securities lending and repo financing in just three sentences at the outset.

explains that "whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements."[6] This statement is simply not true in the case of U.S. registered funds. Far from being subject to little or no oversight, these funds are among the most highly regulated firms in all financial services. They engage in securities lending and repo in accordance with the Investment Company Act of 1940 (the "ICA") and only if permitted by their organizing documents, disclosed to investors in their prospectus or statement of additional information ("SAI"), and subject to approval and oversight by their boards of directors. And these particular investment techniques also are highly regulated. The staff of the U.S. Securities and Exchange Commission ("SEC") has established guidelines for securities lending activities for registered funds. Among other things, these guidelines restrict the types of collateral that are permissible and how that collateral may be treated, impose limitations on the amount of lending, ensure the ability of a fund to recall securities in a timely manner, and address potential conflicts of interest. Similarly, Rule 2a-7—the primary rule under the ICA that regulates U.S. money market funds—imposes strict minimum standards for the credit quality, maturity, diversification and liquidity requirements of a money market fund's investments, including repos. In addition, the rule requires the funds to evaluate the repo counterparty's creditworthiness as a prerequisite to engaging in a repo transaction.

Moreover, market practices with respect to both securities lending and repos in the U.S. have been enhanced since the 2008 crisis in many ways that significantly reduce intraday credit risk, increase transparency (including with respect to extensive disclosure requirements as to fund holdings and performance), and mitigate counterparty credit, liquidity, and credit quality risks. These developments are discussed at length in our letter on the FSB's initial consultation.[7]

We continue to believe that, in addition to protecting investors, many of the regulatory requirements and recent market developments should allay the FSB's financial stability concerns with respect to U.S. registered funds' participation in the securities lending and repo markets. We respectfully request that the FSB's final report explicitly recognize as much.

Style of Recommendations

The FSB has taken on a difficult task—to make policy recommendations that are general enough to cover both securities lending and repo, specific enough to resonate in many different jurisdictions around the world, flexible enough to be implementable by national and regional regulators, yet prescriptive enough to prevent the potential for "regulatory arbitrage."

In our view, trying to achieve all of these objectives is neither achievable nor necessarily desirable in every context addressed in the Consultation. Regulators around the world ought to be fully

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[6] Consultation, at page ii.

[7] *See* the 2012 ICI Letter.

aware of each other's approaches and ought to coordinate where possible, particularly in areas such as the gathering of data for regulatory purposes where consistency of approach will both increase efficiency and improve results. But given the differences between securities lending and repo markets, and differences between jurisdictions, absolute global regulatory consistency is not always the best outcome.

In a number of places in the Consultation, the FSB's proposed recommendations are prescriptive, stating, for example, that national regulators "should adopt" certain minimum regulatory standards.[8] We recommend that the FSB take a less prescriptive approach with its final recommendations. In each case, the FSB should encourage national regulators *to consider* its recommendations, rather than directing them to adopt a specific type of requirement. That kind of approach would allow national regulators to implement the FSB's recommendations in ways that take into account existing regulations and local practices that mitigate systemic risk concerns. It might allow U.S. regulators, for example, to tailor their policy approach to repos, given the uniqueness of the tri-party structure common in the U.S.

Enhanced Transparency

The Consultation includes a number of policy recommendations that seek to improve securities lending and repo transparency in four areas: 1) regulatory reporting; 2) market data; 3) corporate disclosures; and 4) reporting by fund managers to end-investors.

Regulatory Reporting

We support many of the FSB's goals and recommendations in the first area—regulatory reporting. Without question, the relevant authorities should have the information they need to effectively monitor securities lending and repo markets for systemic risks. We also strongly support the FSB's role in this regard, as a global approach to the collection of data would benefit everyone involved. Regulators around the world would gain access to consistent and comprehensive data without imposing duplicative or incompatible reporting obligations on market participants.

As a word of caution, however, we offer three core principles that the FSB should reflect in its final recommendations. In gathering data, authorities should obtain only the information they need to monitor for systemic risks in the markets; authorities should gather that information in the most efficient way reasonably available; and authorities should have appropriate systems and procedures in place to ensure the confidentiality and security of such information before requesting it from market participants.

In Box 1, the Consultation sets forth an extensive list of information WS5 believes would be useful to help authorities monitor the size and risk characteristics of securities lending and repo markets

[8] *See also* Recommendations 6, 8, 9, and 11.

over time in order to detect financial stability risks. Before making final recommendations that regulators should collect all of the information on that list, the FSB should ensure that each element is *necessary* to fulfill the purposes for the data collection. That analysis is lacking in the Consultation, as nearly all of the discussion of the relative costs and benefits of this data collection focuses on the method of gathering the data (reporting, surveys, or trade repositories) rather than the data itself. The FSB clearly recognizes that the collection of data imposes costs and burdens on market participants; it must guard against recommendations that instruct regulators to collect data that is not necessary to detect financial stability risks in these markets.[9]

After determining the appropriate universe of data to be collected, authorities should obtain it in the most efficient way reasonably available. We appreciate that the FSB is considering carefully the costs and benefits of reporting, surveys, and trade repositories. In addition, the FSB should obtain data from major market participants whenever possible. In both the securities lending and tri-party repo markets, a majority of transactions involve a relatively small number of entities—lending agents or repo clearing banks, respectively. These entities currently are looked to as primary sources of data, and should continue to be viewed as such if authorities collect data through reporting obligations or surveys. Reporting obligations should extend to individual market participants only when the information that can be collected from these primary sources proves insufficient for the authorities' purposes.[10]

Finally, it is likely that some of the information collected will be commercially sensitive. Regulators must have appropriate systems and procedures in place to ensure the confidentiality and security of such information before requesting it from market participants.

In sum, the collection of data by regulators is one area where we favor a globally harmonized approach through which regulators could gain access to consistent and comprehensive data without imposing duplicative or incompatible reporting obligations on market participants. This process, however, will need to be developed through further consultations with industry and a careful review of

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[9] In determining that universe, the FSB should note that a great deal of progress has been made in the U.S. on this front in recent years as the SEC and Federal Reserve have gathered better and more comprehensive data through surveys and new regulatory reporting obligations. For example, the Federal Reserve Bank of New York (the "FRBNY") has increased its monitoring and data gathering on both the tri-party repo and securities lending markets since the crisis, working closely with industry representatives in various task forces and working groups. In addition, the SEC has adopted new rules requiring money market funds to disclose holdings on a more detailed and frequent basis on Form N-MFP. *See* SEC Release No. IC-29132 (Feb. 23, 2010), available at http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[10] Conceptually, this is similar to new rules for the reporting of swap data in the U.S., which create a hierarchy that gathers data from entities like swap execution facilities and designated contract markets before imposing reporting obligations on individual counterparties. As the U.S. Commodity Futures Trading Commission explained, the "swap data reporting provisions were designed to streamline and simplify the data reporting approach, by calling for reporting by the registered entity or counterparty that the Commission believes has the easiest, fastest, and cheapest access to the data in question." *See Swap Data Recordkeeping and Reporting Requirements*, 77 Fed. Reg. 2136, 2142 (Jan. 13, 2012), available at http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-33199.

existing processes and available information. We look forward to working with the FSB and national regulators on further efforts in this regard.

Market Data

We generally support the public release of aggregated data to the extent that such disclosure is meaningful and advances the goal of mitigating systemic risk. As we explained in the 2012 ICI Letter, institutional participants in the securities lending and repo markets do not necessarily see a compelling need for greater market transparency, as there is a substantial amount of information available to institutional investors in these markets. That said, if authorities have access to more complete data via a trade repository, surveys, or regulatory reporting, some systemic risks may be mitigated through the public release of at least some of that data on an aggregated basis.[11]

We have one important caveat. The economic terms of securities lending transactions should not be disclosed to the public. The parties to securities loans negotiate their economic terms taking into account a myriad of factors, including the nature of the security, the anticipated return on reinvested collateral, the identity of the borrower, the relationship between the borrower and lender, the relationship between the lender and its agent, and current market conditions. No single piece of this data set is particularly meaningful without the others. As a result, releasing an aggregate figure or set of figures will convey very little meaningful information, and ultimately may prove more confusing than informative. Moreover, even if it were possible to disclose aggregated data on these terms in a meaningful way, it is difficult to see how such disclosure would be necessary to mitigate systemic risks. Accordingly, we request that the FSB's final recommendation on market transparency for securities lending not include items such as securities lending fees or rates and breakdowns of fees and cash investment returns.[12]

Corporate Disclosures and Reporting by Fund Managers to End-Investors

While we strongly support regulators having access to the information they need to monitor for systemic risks and support the public release of at least some of that information on an aggregated basis, we oppose the FSB's recommendations in the other two areas addressed in the Consultation's discussion on transparency—corporate disclosure and fund manager disclosure. While we support transparency in these areas, it is essential that the FSB defer to local authorities on these particular issues. Corporate disclosures provided through financial statements and shareholder reports are

[11] The FSB should carefully consider, however, whether the release of each type of data, even in aggregated form, might have the unintended consequence of actually increasing systemic risk.

[12] We recognize that the Consultation merely includes "lending rates" in its list of aggregate data to be published (see page 7), and that this differs from the "securities lending fee or rate, including breakdown of fee and cash investment return" proposed to be collected via a trade repository (see page 6). The FSB should clarify its use of the term "lending rates" in this context.

primarily intended to serve the needs of investors and other stakeholders. Accounting standard setters and securities regulators are best positioned to ensure that corporate disclosures are fulfilling this purpose.

The Consultation recommends, with respect to corporate disclosure, that firms disclose a considerable amount of qualitative information, including counterparty concentration, maturity breakdowns, the composition of securities lent or borrowed or used in a repo and the collateral received, information on margins, and more. We cannot support this recommendation both because it is unnecessary given the robust corporate disclosure provided by U.S. registered funds[13] and because the nexus between increased corporate disclosures and the FSB's mandate—systemic risk regulation—is tenuous. The Consultation explains that "WS5 found that [corporate disclosure] 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." Even if that is true, corporate disclosures will never provide regulators with more or better data than the FSB is contemplating that regulators gather through surveys, regulatory reporting, and/or trade repositories. The FSB should remain focused on those methods to help regulators obtain the data they need; policy decisions on corporate disclosures should be left to the appropriate national regulators.[14]

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[13] As we explained in the 2012 ICI Letter, U.S. funds are required to provide a high degree of corporate disclosure to investors about their securities lending and repo activities. A fund must disclose that it may lend securities or engage in repurchase transactions. This disclosure appears in the fund's prospectus and SAI, both of which are available to investors, the SEC, and the public. Twice a year, funds also prepare financial statements that are filed with the SEC and sent to shareholders. As a result of SEC regulation, we believe the level of detail provided in fund financial statements exceeds that provided by virtually any other type of corporate entity. For example, for securities loans the fund's financial statements identify securities out on loan, investment of cash collateral received, a liability reflecting the obligation to return the cash collateral at the conclusion of the loan, and income earned from securities loans. Fund financial statements provide a similar level of detail on repos (both lending and borrowing transactions). In addition to the semi-annual financials in these shareholder reports, funds also file Form N-Q after the first and third quarters, which includes a detailed listing of the fund's portfolio. The filings on Form N-Q identify those securities out on loan, securities sold subject to an agreement to repurchase, and investments in repos (including collateral received).

In addition, money market funds are required to post their portfolio holdings on their websites each month within five business days after month end. Money market funds also are required to file Form N-MFP with the SEC on a monthly basis. This provides details on the fund and its portfolio holdings (including detail on each security held as collateral), and has given regulators in the U.S. and the public significantly enhanced transparency with respect to money market funds' role in tri-party repos.

[14] For example, the Financial Accounting Standards Board (FASB) in the U.S. is currently working on a project intended to improve accounting and disclosure practices relating to repos and similar transactions. In particular, we understand the FASB is considering changes that would a) result in additional types of sale and repurchase transactions to be accounted for as secured borrowings, and b) for repos characterized as secured borrowings, require disclosure of a disaggregation of the amount of the borrowing (the repurchase liability) based on the type of financial asset pledged as collateral. Additional information on the FASB project is available here:
http://www.fasb.org/cs/ContentServer?site=FASB&c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176159942530#objective.

Likewise, policy decisions on fund manager disclosure to end-investors are best handled by national regulators. There is little nexus to systemic risk here, and indeed the FSB does not attempt to draw *any* link to financial stability concerns in this section of the Consultation. It merely suggests that additional information "needs to be frequently disclosed . . . in order to allow investors to select their investments with due consideration of the risks." The Consultation then lists 24 separate pieces of information that WS5 believes could be reported to end-investors and makes a recommendation that authorities "should review reporting requirements for fund managers to end-investors in line with the proposal by the Workstream."

We have concerns with this recommendation both substantively and conceptually. Substantively, the disclosure suggested by the FSB is excessive for many registered funds that engage in a limited amount of securities lending or repo, and even inappropriate in certain jurisdictions, such as the U.S., where there are regulatory limits on the extent of a registered fund's participation in securities lending or repo. The substance, frequency, and amount of disclosure on any given topic should be commensurate with the materiality of that information to investors; the extent of fund disclosure on an investment strategy should be reasonably related to the importance of that strategy to the overall risks and returns of the fund.[15] While fund managers should be required to disclose information necessary to allow investors to select investments with due consideration of the risks taken by the fund, policy decisions about the contours of that disclosure should be left to the appropriate national regulator's discretion to determine.[16]

Moreover, conceptually, it is inappropriate for the FSB to single out *fund managers* for a discussion on the appropriateness of *their* investor disclosures. Fund managers are but one type of securities lender or repo counterparty, along with pension funds, insurance companies, and others. And, more broadly, registered funds are but one of a number of financial firms involved in these markets, and not necessarily the most important when thinking about transparency and systemic risk issues.[17] The FSB offers no justification for uniquely addressing disclosure by fund managers, and we cannot discern any reason why it should do so.

[15] See, *e.g.*, *Registration Form Used by Open-End Management Investment Companies*, SEC Release No. IC-23064 (Mar. 13, 1998), available at http://www.sec.gov/rules/final/33-7512r.htm (directing U.S. mutual funds, whenever possible, to "avoid a disproportionate emphasis on possible investments or activities of the fund that are not a significant part of the fund's investment operations").

[16] In the U.S., the SEC very actively oversees fund disclosures, both through periodically reexamining the effectiveness of the current disclosure regulatory regime and through SEC examiner review of individual fund disclosure.

[17] For example, the U.S. Congress recently addressed securities lending transparency by focusing on securities borrowers and lenders, rather than fund shareholders. *See* Section 984 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Regulation of Securities Financing

Our comments on section 3 of the Consultation focus on three areas: the concept of minimum haircuts on repos (section 3.1); securities lending cash collateral reinvestment (section 3.2); and minimum standards for collateral management with respect to repos (section 3.4).

Minimum Haircuts on Repos

The primary recommendations in this section of the Consultation are that regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral haircuts and consider minimum numerical floors for haircuts. For a number of reasons, we believe that the FSB's focus on haircuts is misplaced, particularly with respect to any attempt to set specific fixed or minimum numerical floors.

First, we fundamentally disagree with any attempt to regulate the negotiated terms of market transactions such as repos. We doubt that the FSB would ever consider recommending a floor for the rates charged by buyers in repos or on the duration of the agreements. Such terms are best set by market forces, responding to current market conditions and a multitude of other factors that regulations can never adequately capture. Haircuts are no different from these other terms of a repo and therefore should not be dictated by regulations.

Second, the Consultation presupposes pro-cyclical trends in haircuts for which there is no historical evidence, at least for tri-party repo in the United States. A study of tri-party repo haircuts during the "crisis period" of July 2008 to July 2009 and of the "stable period" from July 2009 to January 2010 concluded that "the average haircut across all collateral types is roughly equal across the two periods."[18] The same study also reviewed Lehman Brothers' haircut levels prior to its filing for bankruptcy and concluded that "the haircuts faced by Lehman Brothers barely moved until the event date [bankruptcy filing]."[19] Lastly, after analyzing the effect of other shocks on stressed dealers the study concluded that "[d]ealers that were hit with adverse shocks could continue to fund themselves by the same amount and without significant changes to haircuts."[20] Therefore, research in the tri-party repo market indicates, contrary to the Consultation's premise, that margin haircuts are not pro-cyclical in nature but rather change very little during crisis or stress periods.

Indeed, requiring buyers to base their collateral requirements solely on the historical volatility of the collateral, without regard for the financial strength of the seller, actually could *introduce* systemic risk into the financial system. If markets for a particular collateral type grow more volatile, buyers using

[18] *Repo Runs: Evidence from the Tri-Party Repo Market*, Copeland, Martin and Walker, Federal Reserve Bank of New York Staff Reports, no. 506, July 2011; revised March 2012.

[19] Copeland, Martin and Walker at 26.

[20] Copeland, Martin and Walker at 29.

the method proposed in Recommendation 6 would uniformly increase their haircuts for that collateral. This would reduce the financing available for the collateral and increase the risk of carrying the collateral. The resulting reduction in market liquidity would increase the volatility of the collateral, leading to further increases in haircut requirements.

Third, the key principles of Section 3 of the Consultation do not account for the fact that many buyers enter into a repo based primarily upon the seller's capacity to pay the repurchase price, rather than upon the value and liquidity of the collateral. U.S. money market funds, for example, are required by regulation to evaluate the seller's creditworthiness as well as determine that the repo presents minimal credit risks.[21] This practice is not limited to money market funds; it is common for financial managers to establish a general credit limit for an institution based on its overall creditworthiness and to count all financial obligations—including deposit obligations (in the case of banks), commercial paper, notes, trading obligations (including repos), and securities lending obligations—against this limit.

This practice is not pro-cyclical, insofar as increases in the value of collateral do not necessarily increase an institution's credit limit. Changes in its credit limit reflect changes in the financial strength of the institution and the risks taken in its business, which may be affected positively or negatively during a financial growth cycle. Under this approach, a financial manager considers collateral as one factor (along with rate, term, liquidity and other factors) when deciding what form of credit to extend to an institution, but it does not dictate the amount of credit extended.

Imposing arbitrary floors for collateral haircuts will therefore preclude some creditors from providing financing in the most efficient and beneficial manner, without reducing the overall amount of leverage in the financial system. Floors may create an unintended bias against collateralized financing or promote the development of more complex and less efficient collateral arrangements than repos. Prescriptive methods for establishing haircuts, such as those proposed in Recommendation 6, would tend to have the same effects, as they would require that buyers conduct a collateral analysis that has no bearing on their decision to extend credit to a seller.

Fourth, for most categories of collateral, the proposed floors (even the "backstop" levels of Option 2) are much higher than the haircuts currently prevailing in the market. The Consultation correctly identifies (on page 14) many of the problems that would result from such floors, including:

- "[a] large negative impact on the liquidity of the repo and secondary markets for the affected securities if transactions currently take place at haircuts below the required levels";

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[21] *See* Rule 2a-7(c)(4)(ii)(A) under the ICA.

- "reduce[d] incentives for market participants to conduct their own haircut calculations with a risk that the numerical floors become de facto market standards";

- "distortions in markets (*e.g.* incentives to use collateral securities at the longest maturities or highest credit risk allowed within each bucket)"; and

- "an increased recourse to central bank refinancing operations if central bank haircut schedules are lower."

These problems illustrate why, as was noted at the outset, limiting the market's ability to set the terms of repos, including haircuts, would be a counterproductive policy.

Finally, the proposed floors may create systems limitations that prevent the development of better collateral management practices. Every subdivision of collateral type (*e.g.*, maturity, credit quality) requires a corresponding database to classify the collateral and a system to sort collateral and apply the required haircut. Establishing a regulatory template for collateral would increase the difficulty of convincing dealers and tri-party custodians to accommodate different collateral classifications and haircuts. The floors are likely to become de facto market standards because, having already incurred the expense of bringing their systems into compliance with the floors, market participates will not want to pay for further systems enhancements.

Cash Collateral Reinvestment

As explained in the 2012 ICI Letter, U.S. registered funds almost always receive cash collateral for securities lending transactions. The cash collateral is typically reinvested in very high quality, highly liquid investments. These are often U.S. money market funds managed pursuant to Rule 2a-7 or other funds managed with very conservative short-term investment strategies. These funds often have a principal investment objective of seeking the highest possible level of current income while still maintaining liquidity and preserving capital. Accordingly, we view the recommendations in the Consultation as broadly consistent with the types of cash collateral reinvestment currently practiced by U.S. registered funds.[22]

We request one clarification, however. The Consultation states that "securities lending cash collateral reinvestment should be conducted with one of the primary objectives being capital preservation." We request that any final FSB recommendation along these lines make clear that cash collateral may be invested in funds that seek a reasonable rate of return generally consistent with capital preservation.

[22] With respect to U.S. funds, we interpret the FSB's recommendations to allow cash collateral reinvestment in money market funds operated pursuant to Rule 2a-7 as well as other funds, such as those managed to be consistent with the requirements of Rule 2a-7 prior to the 2010 amendments to that rule.

Minimum Standards for Collateral Management

In section 3.4 of the Consultation, the FSB proposes certain principles on collateral valuation and management by market participants that would serve as "minimum regulatory standards" for authorities to implement. While no one denies the need for firms to employ appropriate collateral management practices, we do not believe it is necessary for the FSB to make these recommendations given that, even without additional regulations, market forces have driven significant enhancements to collateral management practices since 2008. We also disagree with the FSB's first principle in this section—that 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 hold outright without breaching laws or regulations—which has more to do with who can participate in the repo and securities lending markets than it does with collateral management.

Without additional regulations, the market has already enhanced its collateral management practices. As explained in the 2012 ICI Letter, a special Task Force on Tri-Party Repo Infrastructure (the "Task Force") was formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the FRBNY. ICI participated on the Task Force along with several representatives from ICI member firms. The Task Force considered collateral and counterparty concerns at length, making several notable risk reducing recommendations.[23] Many of these—including moving the daily "unwind" of most tri-party repo transactions from early morning to mid-afternoon, having the tri-party clearing banks implement automated collateral substitution capabilities, and three-way trade confirmations—have now been implemented.[24]

More specifically, the U.S. market has already implemented two of the three principles set forth in section 3.4 of the Consultation—the second and third proposed standards for collateral valuation and management—without any regulatory intervention. Daily valuation and margin calls have long been an established practice in the U.S. repo market, without having ever been required by regulation. And ICI has provided its members with a checklist to assist in developing a contingency plan in the event of a dealer default.[25]

We recognize that it still may be appropriate for regulators to encourage market participants to develop and document collateral management practices appropriate to their business. This could include, in addition to the last two principles of section 3.4, the practices relating to the establishment and review of appropriate haircuts discussed in section 3.1. As reflected by the ICI default checklist, we agree that counterparties should carefully consider the type, amount, valuation and safekeeping of

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[23] The final report of the Task Force is available at http://www.newyorkfed.org/tripartyrepo/pdf/report_120215.pdf.

[24] The 2012 ICI Letter describes these developments in more detail.

[25] This checklist is designed primarily to detail the steps that a fund investor would take in order to liquidate securities subject to a repo with a dealer that becomes insolvent after entering into the repo. It is available at http://www.ici.org/policy/current_issues/11_mmf_repo_checklist.

collateral, as well as its possible disposition following a default. There is no standard set of practices, however, that is appropriate or even necessary for all firms to use for collateral management. Like other risk management matters, firms should be encouraged to address collateral management issues without prescribing how issues must be addressed.

We question the FSB's other principle in section 3.4 for different reasons. It states that securities lending and repo market participants should only take collateral types that they are able, following a counterparty failure, to hold outright without breaching laws or regulations. The basis for this principle is set out earlier in the Consultation, where the FSB explains:

> Following a counterparty default, some creditors in the repo financing and securities lending segments are likely to sell collateral securities immediately, because of regulatory restrictions on portfolio holdings, limited operational or risk management capacity, or a need for liquidity. This may lead to sharp price falls that create mark-to-market losses for all holders of those securities. These losses can in turn lead to fresh rounds of fire sales by other firms, thereby creating an asset valuation spiral.[26]

The reference to "regulatory restrictions on portfolio holdings" suggests that the FSB is concerned that buyers (*i.e.*, collateral-takers) are driven to sell collateral after a default in order to comply with legal requirements, rather than being motivated by economic concerns. This is a mistaken premise that is at odds with the fundamental nature of repos and the economic reasons for entering into them. Buyers enter into repos expecting the seller to repurchase the collateral. If the seller defaults, the buyer expects to recover the repurchase price by selling the collateral—not holding it. If the buyer wanted to own the repo collateral it would have bought those securities outright, rather than through the repo. Thus, a buyer never enters into a repo with the intent of holding the underlying securities and, upon a default, would be expected to sell the collateral in a manner that minimizes its exposure to the collateral's market risks, even when permitted by laws or regulations to continue to hold the collateral.

Insolvency laws may reinforce the economic incentive to sell collateral as rapidly as possible. For example, a U.S. bankruptcy court rejected a buyer's deficiency claim against a bankrupt seller based on the "commercially reasonable determinants of value" of the underlying collateral on the date the repo was accelerated, even though the buyer did not recover the determined value upon disposition of the collateral.[27] The need to establish a liquidated claim against the seller's estate may incentivize a buyer to sell the collateral immediately following the seller's insolvency.

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[26] Section 1.2(ii) of the Consultation.

[27] *In re American Home Mortgage Holdings, Inc.,* 411 B.R. 181 (Bankr. D. Del. 2009); *see also In re Lehman Brothers Holdings Inc.,* Case No. 08-13555 (JMP), Sept. 15, 2009 Hr'g Tr. [ECF No. 5261] (Bankr. S.D.N.Y. 2009) (holding that a counterparty who waited approximately eleven months without terminating its derivative contract with the debtor had waived its right to do so).

Such economic concerns are far more likely to motivate a rapid disposition of repo collateral than any legal concerns. In any event, U.S. laws and regulations do not require investment companies to engage in any "fire sale" of repo collateral following a seller's default or insolvency. Following a default on any portfolio security, including a repo, Rule 2a-7 only requires a "money market fund [to] dispose of such security as soon as practicable consistent with achieving an orderly disposition of the security."[28] A disposition is not required, however, if "the board of directors [finds] that disposal of the portfolio security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security)." Both of these provisions are expressly intended to promote an orderly disposition of holdings, including collateral securing a repo, following a default, rather than a fire sale.

The SEC has indicated that, if a default under a repo caused a money market fund's weighted average maturity to exceed 60 days, the fund should "dispose of the collateral as soon as possible."[29] The SEC has never suggested, however, that this would require an immediate disposition of the collateral without regard to existing market conditions. Historically, the SEC has permitted funds to deal with such events in a reasonable manner that safeguards the interest of their shareholders. For example, after several structured investment vehicles defaulted in 2007, the SEC permitted money market funds holding interests in these vehicles (the portfolios of which had average weighted maturities far in excess of Rule 2a-7's limitations) to spend several months restructuring and selling their interests.[30] We would expect the SEC to continue to follow this practice, as it serves the interests of both the funds' shareholders and of the financial markets generally.[31]

We also object to the prescriptive nature of the principle, which would dictate the terms on which one firm could provide funding to another. While some firms may decide to follow this principle, there is no reason that everyone must do so. Lenders routinely take collateral that is wholly unrelated to their business and which they are permitted to hold only for purposes of disposition. For example, banks may take medical equipment as collateral even though they do not have a license to use the equipment to practice medicine. The Consultation does not provide any justification for such a

[28] Rule 2a-7(c)(7)(ii). Even if the SEC were to treat a money market fund as holding the repo collateral outright following a default, this provision would govern the disposition of any collateral that was not an "eligible security" under Rule 2a-7 or was not determined to present minimal credit risks.

[29] Revisions to Rules Regulating Money Market Funds, SEC Release No. IC-18005 (February 20, 1991), 56 FR 8113 (February 27, 1991), at n.33.

[30] If the SEC shares the FSB's concerns over the potential fire sale of collateral following a default, it could issue additional guidance codifying this position.

[31] Even if the SEC were to require inclusion of repo collateral in the calculation of a fund's weighted average maturity, the consequence would not be a "breach" of any law or regulation. A money market fund that fails to satisfy the conditions of Rule 2a-7 (such as exceeding the 60-day limit) must stop using amortized cost or penny rounding to calculate the net asset value of its shares, but it does not violate any provision of the ICA or other securities laws by continuing to hold the collateral.

unique standard on repos. It also does not explain how the standard pertains to the management of collateral. The standard seems aimed more at regulating what firms can engage in repo than how they should manage repo collateral.

For all of these reasons, we recommend that the final FSB recommendation on collateral management not limit repo market participants to collateral that they are able to hold outright following a counterparty failure (*i.e.*, that the FSB strike the clause in section 3.4(1)(i) of the Consultation). The proposed recommendation might be misinterpreted to restrict repo buyers only to collateral that they could have purchased outright and held indefinitely for investment. As explained, such a restriction would be inconsistent with the fundamental nature of a repo, where the collateral is not the driving component of the investment decision, and would unduly restrict the market without lessening the risk of a fire sale.

* * * *

We appreciate the opportunity to comment on this important consultation. If you have any questions about our comments or would like additional information, please contact me at 202/371-5430, Dorothy Donohue, ICI's Deputy General Counsel – Securities Regulation, at 202/218-3563, or Brian Reid, ICI's Chief Economist, at 202/326-5917.

Sincerely,

/s/ Robert C. Grohowski

Robert C. Grohowski
Senior Counsel

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November 27, 2013

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

Re: Proposed Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions (Annex 2 of August 29, 2013 Report on Strengthening Oversight and Regulation of Shadow Banking)

Dear Sir or Madam:

The Investment Company Institute[1] and ICI Global[2] appreciate the opportunity to comment on the Financial Stability Board's proposed regulatory framework for haircuts on non-centrally cleared securities financing transactions (the "Margin Consultation").[3] Given the extent of their participation in the securities lending and repo markets, investment funds worldwide have a strong interest in the FSB's recommendations in this area.[4]

Although we commend the FSB for seeking to identify and address systemic risk concerns in securities lending and repo markets, we continue to have serious reservations about the FSB's recommendations relating to margin haircuts. In our view, the FSB's focus on haircuts is misplaced and its recommendations inappropriately dictate terms best left to the parties to negotiate.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.7 trillion and serve over 90 million shareholders.

[2] ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion.

[3] *Strengthening Oversight and Regulation of Shadow Banking, Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (August 29. 2013), available at http://www.financialstabilityboard.org/publications/r_130829b.pdf.

[4] ICI and ICI Global have submitted a number of comment letters to the FSB in connection with its consultations on securities lending and repo markets. Appendix A contains a list of our comment letters to date.

Our specific comments on the Margin Consultation follow. Preliminarily, however, there is one aspect of the FSB's final recommendations that warrants comment from our perspective. We were disappointed that the FSB chose to include in its policy recommendations a section on fund manager disclosure to end investors, adopted word-for-word from the FSB's 2012 consultation.[5] While we support transparency, we are troubled that the serious concerns we expressed over this recommendation were not addressed in any way. We continue to believe that it is inappropriate for the FSB to single out *fund managers* for a discussion on the appropriateness of *their* investor disclosures, particularly given that the FSB does not attempt to draw *any* link to financial stability concerns in this context. Fund managers are but one type of securities lender or repo counterparty, along with pension funds, insurance companies, and others. And, more broadly, registered funds are but one of a number of financial firms involved in these markets, and not necessarily the most important when thinking about transparency and systemic risk issues.[6] The FSB offered no systemic risk justification for uniquely addressing disclosure by fund managers in its 2012 consultation, and offers none now in its final policy recommendations. Frankly, we cannot discern any reason why the FSB should single out fund managers in this regard.

Moreover, substantively, the disclosure suggested by the FSB may well be excessive for many registered funds that engage in only a limited amount of securities lending or repo. The substance, frequency, and amount of disclosure on any given topic should be commensurate with the materiality of that information to investors; the extent of fund disclosure on an investment strategy should be reasonably related to the importance of that strategy to the overall risks and returns of the fund.[7] In jurisdictions such as the U.S., where there are regulatory limits on the extent of a registered fund's participation in securities lending or repo, such extensive disclosure may be clutter—it may simply serve to obscure far more relevant risk disclosures. While we wholeheartedly agree that fund managers should be required to disclose information necessary to allow investors to select investments with due consideration of the risks taken by the fund, the FSB's sweeping recommendation in this area demonstrates precisely why policy decisions about the contours of that disclosure should be left to the appropriate national regulator's discretion to determine.

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[5] *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, FSB Consultative Document (November 18, 2012), which is available at https://www.financialstabilityboard.org/publications/r_121118b.pdf.

[6] For example, the U.S. Congress recently addressed securities lending transparency by focusing on securities borrowers and lenders, rather than fund shareholders. *See* Section 984 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[7] See, *e.g.*, *Registration Form Used by Open-End Management Investment Companies*, SEC Release No. IC-23064 (Mar. 13, 1998), available at http://www.sec.gov/rules/final/33-7512r.htm (directing U.S. mutual funds, whenever possible, to "avoid a disproportionate emphasis on possible investments or activities of the fund that are not a significant part of the fund's investment operations").

Comments on the Margin Consultation

Our comments on the Margin Consultation focus on two sections: Section 2, which sets forth minimum standards for methodologies used to calculate haircuts, and Section 4, which proposes specific numerical floors for haircuts.

Section 2: Haircut Methodologies

Section 2 of the Margin Consultation sets forth a number of recommendations for methodologies used to calculate risk-based haircuts that appear intended to apply to both securities lending and repo transactions. For the reasons below, we do not believe that they should be adopted for either securities lending or repo transactions.

The FSB's Recommendations Will Not Prevent the Build-Up of Excessive Leverage. The Margin Consultation assumes a direct relationship between the size of haircuts for repos and securities lending transactions and the amount of leverage in the financial system. This is a flawed assumption. Even looking at repos and securities lending in a vacuum, any decrease in leverage that results from an increase in haircuts would be insignificant. For example, suppose a broker-dealer has $102 million of general collateral available for repo transactions. At a standard haircut of 2%, the broker-dealer could raise $100 million through repos using this collateral. If the haircut were increased to 4%, the broker-dealer could still raise $98.077 million. Thus, doubling the haircut on repos would result in less than a 2% reduction in the broker-dealer's leverage.

Moreover, the assumption ignores the fact that repos and securities lending cannot be viewed in a vacuum. Firms may obtain credit in a variety of ways, including by obtaining secured and unsecured bank loans, selling assets to asset-back securities conduits, issuing bonds and commercial paper, as well as entering into repos and engaging in securities lending. Instead of reducing the amount of leverage in the financial system, requiring less favorable terms for one form of credit may simply force firms to obtain credit in other ways. Any reduction in repos and securities lending likely will be offset by increases in other, cheaper forms of credit.

Changes in Margin Haircuts Have Not Been Pro-Cyclical. Our comments on the 2012 consultation provided evidence that neither securities lending nor repurchase agreements have been subject to pro-cyclical variations in margin haircuts. The current consultation fails to respond to this evidence. We continue to believe that standard practices regarding margin haircuts are not pro-cyclical, and that, rather than decreasing the risks of procyclicality, the proposed methodology may increase the risk of credit disruptions.

With respect to securities lending transactions, haircuts are not typically set on a variable, risk-based basis. In the U.S., Securities and Exchange Commission (SEC) guidelines require that funds lending securities receive at least 100 percent of the value of the loaned securities as collateral from a borrower. The value of the collateral must be marked-to-market daily and adjusted so that the obligations are fully collateralized at all times. As a practical matter, securities lending agreements typically apply a haircut, usually 102 percent for loaned domestic securities and U.S. dollar denominated foreign securities and 105 percent for loaned foreign securities.

These standardized two and five percent haircut levels do not fluctuate based on stresses in the market—they are not lowered in benign market environments, nor raised in volatile markets. Moreover, the problems identified during the recent crisis with respect to securities lending collateral did not have to do with inadequate amounts of collateral; rather, the problems stemmed from losses and a lack of liquidity in certain cash collateral reinvestment pools, particularly those not managed in accordance with Rule 2a-7 under the Investment Company Act.

Given all of that, the FSB's recommendation to require securities lending market participants to develop detailed methodologies to calculate risk-based haircuts is misplaced. The primary purpose for that recommendation—in the FSB's words, "to limit potential procyclical fluctuations, *i.e.* to moderate the extent by which the haircuts decline in benign market environments (and thus mitigate the magnitude of the potential increase in volatile markets)"—already is satisfied by the use of standardized two and five percent haircuts that do not fluctuate in times of stress.

As we pointed out in our earlier comment letters, research in the tri-party repo market indicates, contrary to the Margin Consultation's premise, that margin haircuts in the repo market also are not pro-cyclical in nature but rather change very little during crisis or stress periods.[8] While SEC guidelines require that funds lending cash in a repo transaction be fully collateralized at all times, repo transactions are typically over-collateralized at levels ranging from 102 percent to 110 percent, demonstrated by the collateral haircut data published monthly by the Federal Reserve Bank of New York.[9] This data also shows little fluctuation in the range or median margin requirements for investment grade and equity collateral. Again, the value of the collateral must be marked-to-market daily and adjusted so that the obligations are fully collateralized at all times.

A Prescriptive Methodology May Create a De Facto Floor. Although the FSB separates its discussion of haircut methodologies from numerical haircut floors, the two approaches ultimately may produce the same result, as detailed minimum methodologies could have the practical effect of establishing minimum haircuts. For example, if market participants are required to calculate their haircuts by looking back at a similar period for price data for a type of collateral (*e.g.,* at least two years and covering at least one stress period for that type of collateral), use a similar confidence level in the calculation (*e.g.,* at least the 95th percentile, one-tailed confidence level) and a similar liquidation horizon for the collateral (*e.g.*, conservative period that reflects expected liquidity in stressed market

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[8] Repo Runs: Evidence from the Tri-Party Repo Market, Copeland, Martin and Walker, Federal Reserve Bank of New York Staff Reports, no. 506, July 2011; revised March 2012.

[9] *See, e.g.*, daily average collateral value and margin trends in the tri-party repo market, available at http://www.newyorkfed.org/banking/pdf/daily_avg_size_tpr_Sep2013.pdf.

conditions taking into account trading volumes and market depth) the market participants are likely to arrive at substantially similar haircuts for a type of collateral. This would result in the FSB effectively setting minimum haircuts for collateral in the repo market, which we continue to oppose for the reasons discussed below. Again, we believe market participants should be free to set their haircuts at levels consistent with their own credit policies, repo trading practices and other factors specific to the market participant.

We would also reiterate our early comments regarding how one method may not be appropriate for all counterparties. As noted in our previous letter, U.S. money market funds are required to consider a counterparty's ability to pay the repurchase price when assessing the credit risk of a repo transaction. This methodology, which is widely used by other participants in the repo market, focuses on the counterparty's capacity to repay all of its current obligations from sources other than the liquidation of the collateral. This methodology is appropriate for repos with a counterparty that has access to liquidity from a variety of sources. It may not be appropriate for a prime broker's repos with a hedge fund, for which the only source of repayment would be from liquidation of the fund's portfolio. The "one method fits all" approach proposed in the consultation overlooks such important distinctions.

Section 4: Numerical Floors on Haircuts

We appreciate that the FSB has carefully crafted the scope of its proposed framework of numerical haircut floors to address situations where the primary motive is to provide financing to non-banking entities. Accordingly, the FSB has excluded cash-collateralized securities lending and limited the scope to "non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing from regulated financial intermediaries against collateral other than government securities." This formulation correctly excludes transactions backed by government securities and transactions where the non-bank is *providing* financing, such as where it is the repo cash lender. Narrowing the scope in these ways alleviates many of our concerns.[10]

That said, we continue to believe that the FSB's efforts to prescribe specific fixed or minimum numerical haircut floors is both unwarranted and unnecessary. Fundamentally, we believe that the economic terms of a repo are best set by market forces, responding to current market conditions and a multitude of other factors that regulations can never adequately capture. Moreover, as noted above and in prior comment letters, research in the tri-party repo market indicates, contrary to the Margin

[10] The FSB's recommendations on haircut methodologies, however, may undermine its policy decisions with respect to the scope of its proposed framework of numerical haircut floors. As noted above, the two approaches ultimately may produce the same result as detailed minimum methodologies could have the practical effect of establishing minimum haircuts, and thus the broader scope of the recommendations on methodologies may override the narrower scope of the recommendations on numerical floors. To avoid that result, if the FSB goes forward with these recommendations, it should adopt the narrower scope used in this section for both haircut methodologies and numerical floors.

Consultation's premise, that margin haircuts are not pro-cyclical in nature but rather change very little during crisis or stress periods. This may be, in part, because buyers enter into a repo based primarily upon the seller's capacity to pay the repurchase price, rather than upon the value and liquidity of the collateral.

That the proposed levels of the numerical floors are lower than those currently employed in the market does not diminish our concerns, but in fact, instead demonstrates the danger in prescribing these types of terms. The 2012 consultation set out a two-tier framework with haircuts that were much higher than were those prevailing in the market. Haircuts at those levels threatened to make repos economically unviable. The Margin Consultation goes the opposite direction, setting out a schedule of haircuts at much lower levels, lower even than many of the levels currently employed. While haircuts at the lower levels suggested by the Margin Consultation would not inhibit repo trading, they run a very real risk of becoming *de facto* market standards. Perversely, this would have precisely the opposite effect as intended, decreasing the protections afforded by collateral and increasing the amount of leverage and risk in the system.

For all of these reasons, we see the FSB's attempt to limit the market's ability to set the terms of repos, including haircuts, to be a counterproductive policy.

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We appreciate the opportunity to comment on this consultation. If you have any questions about our comments or would like additional information, please contact me at 202/371-5430 or rcg@ici.org, Giles Swan, Director of Global Funds Policy at ICI Global at +44 (0) 203 009 3103 or giles.swan@iciglobal.org, or Brian Reid, ICI's Chief Economist, at 202/326-5917 or reid@ici.org.

Sincerely,

/s/ Robert C. Grohowski

Robert C. Grohowski
Senior Counsel

APPENDIX A – Prior Comment Letters to the FSB on Securities Lending and Repo Markets

Letters on WS5's Interim Report

Investment Company Institute, dated May 25, 2012
https://www.financialstabilityboard.org/publications/c_120806p.pdf

ICI Global, dated May 25, 2012
https://www.financialstabilityboard.org/publications/c_120806g.pdf

Letters on the FSB's November 2012 Consultation

Investment Company Institute, dated January 14, 2013
http://www.financialstabilityboard.org/publications/c_130129at.pdf

ICI Global, dated January 14, 2013
https://www.financialstabilityboard.org/publications/c_130129ar.pdf