JFMC | Japan Financial Markets Council

11 January, 2013

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

Submitted by email: fsb@bis.org

Dear Secretariat

Consultative Document: Strengthening Oversight and Regulation of Shadow Banking

1. Introduction

The Japan Financial Markets Council (JFMC)[1] is grateful for the opportunity to respond to the Financial Stability Board's (FSB) consultative document on Shadow Banking which suggests a policy framework for addressing shadow banking risks in securities lending and repos.

Securities lending and repo markets are important to the functioning of the whole financial system. As the consultative paper notes, they play an important role in supporting price discovery and secondary market liquidity for various securities. The JFMC supports the efforts to address the risks to financial stability associated with these markets which play such a crucial role to the wider financial system but we also have some concerns which we outline below. In particular, we strongly believe that mandatory haircuts should not be introduced in order to avoid unintended consequences and the build up of risk elsewhere in the financial system.

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[1] The JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. The current JFMC members are: Bank of Tokyo-Mitsubishi UFJ, Daiwa Securities Group, Mizuho Securities, Nomura Holdings, SMBC Nikko Securities Inc, Bank of America Merrill Lynch, BNP Paribas, Deutsche Bank Group, JPMorgan Securities Japan Co., Ltd. and Morgan Stanley Japan Holdings. The co-chairs of the JFMC are the representatives from Morgan Stanley and Nomura.

We understand that a major objective of the proposals is to constrain procyclical practices and thereby ensure market stability. But it is not clear that all the proposed regulations, particularly mandatory haircuts, will have the desired effects on the market including during times of stress. We believe imposing a minimum standard or numerical floor on haircuts, which is either higher or lower than current market-determined levels, has the potential to disrupt market activities and as a result, may destabilise the financial system and damage the wider economy. During periods of market volatility, market participants (cash lenders) can cut credit lines to control for counterparty credit risk rather than accepting an increased haircut.

2. Sensitive to local markets

Market conditions vary across jurisdictions which the consultative document acknowledges. Assets, regulatory practices, taxation, accounting treatment, the legal framework and market conventions may all vary and imposing a 'one size fits all markets' regime is likely to result in unintended consequences. Japan's market is dominated by highly liquid government bonds, and is one of the largest sovereign debt markets in the world. We thus need to avoid introducing a regime that would damage fiscal funding that comes from this market. There is also a need for more clarity on how some of the proposed rules might affect trading in different jurisdictions. For example, we would appreciate confirmation that the proposed limits on re-hypothecation of client assets do not include securities delivered as collateral (or otherwise) in counterparty transactions such as securities loans, repos or swaps.

In considering new regulations the FSB needs to be aware of the potential for creating regulatory arbitrage which might distort other parts of the market. We also need to avoid undermining emerging markets, such as the tri-party repo market in Japan which is at an early stage of development. We therefore urge that a thorough assessment is made of the possible impact on different markets, so as to avoid situations in which a well intentioned regulation for one market leads to unintended consequences in another.

3. Minimum standards and mandatory numerical floors for haircuts

The consultative paper proposes the introduction of minimum standards for methodologies for haircuts and discusses the introduction of numerical floors for securities-against-cash transactions. We believe there are potential problems with these proposals that would counter the objective to limit their procyclical effect.

Haircuts are dynamic in nature and are determined by a number of factors including: a counterparty's creditworthiness, the nature of their portfolio and the price volatility of each

security. Putting in place minimum standards and predetermined floors is likely to disrupt this balance and possibly undermine risk management practices at individual firms as many will be ‘encouraged’ or ‘incentivised’ to act in a certain way.

If the minimum standard is higher than the market standard the incentive to trade on the part of the party posting collateral is discouraged and only trades at the higher minimum standard would remain in the market. This would have a procyclical effect through the decrease of collateral value or through the termination of a credit line for repos due to the deterioration of a counterparty’s creditworthiness. Also, if a mandatory floor is set higher than the perceived market price it would likely to reduce liquidity as firms ignore what they believe to be the risk-based upper level required and coalesce around a figure that might be regarded by market participants as the accepted norm. This would mean that firms are likely to inflate the figure over and above what the risk analysis might indicate. There would be less variance in the setting of the haircut between transactions and this potentially would have an impact on the overall availability of liquidity. This potentially might destabilise the market and also have an impact on wider market lending and growth generation.

If the minimum standard or mandatory floor is set lower than the market haircut we believe there is a possibility that competition might drive some market participants into adopting this numerical floor level. Rather than act as a back-stop it is likely to become the de facto market level. The impact of this centrally set floor could potentially act as an ‘over-ride’ to a firm’s risk assessment process which may judge the haircut should be higher. This lower floor could therefore also have the potential to exacerbate threats to financial stability.

4. Government bonds and financial stability

We believe that the scenarios outlined above could also apply to sovereign bonds if the proposals were introduced for this asset class. In the case of Japan we believe such an approach could constrain Japanese Government Bond (JGB) transactions both in primary and secondary markets.

The JFMC believes applying minimum standards and numerical floors on haircuts to liquid government bond markets would have a significant negative impact on the liquidity of the repo and securities lending markets. Considering the size and efficiency of the market for Japanese government bonds, even if these measures result in only a small distortion in pricing, the consequences to the funding markets may well be considerable. Other unintended consequences might follow, including a possible disruption of market operations by central banks, or ultimately an impact on the cost of funding by governments. Haircuts should be negotiated bilaterally between counterparties based on creditworthiness and

overseen by appropriate supervisory practices. To do otherwise would affect liquidity, efficient pricing and a fully functioning market.

Security lending and the repo market for government bonds are likely to be tied to central bank operating tools, such as open market operations. The introduction of unilateral numerical haircuts may disrupt the money market operations by the central banks (including in Japan), and rather than lead to stability it could increase the level of instability within the financial system.

5. Interactions with other regulations

The JFMC is supportive of the objective to address the possible build up of risks amongst securities lending and repos but believe that this can be delivered by the current regulatory framework including through Basel III's capital requirements, leverage ratios, new liquidity standards and the countercyclical buffer. The proposals on mandatory floors for haircuts could potentially be both duplicative and have unintended consequences. For example, the demands on market liquidity are high and duplicative demands on it could have negative knock-on effects elsewhere in the system.

The consultative paper is not clear about the position of end-users (individuals and non-bank companies) who are of course not subject to Basel III requirements. Many of them do not have the capability to comply with the proposed regulations and to do so would harm their financial transactions. We therefore believe they should be excluded.

6. Transparency and Data Collection

The JFMC agrees that there is not sufficient data available regarding repos and securities lending. More data about the market would aid transparency and lead to a better functioning market. We support reliance on the potential wealth of information collected by central counterparties (CCPs) or trade repositories, as using this data could be an effective way of obtaining a good overview of market activity and also be more cost effective than obtaining data and collating this from individual firms.

The JFMC believes that any regulatory reporting framework should be applied consistently on a global basis. We believe, however, that such requirements should be implemented only after careful study of market activity in each jurisdiction through close cooperation between regulators and market participants. The results of such studies would provide a basis upon which to conclude what level of data are both available and practical in assisting regulators in monitoring systemic risk in the markets for secured lending and repo transactions. The JFMC anticipates that collecting raw data on each transaction will likely prove impractical,

and would suggest instead gathering transactional data on an aggregated basis, possibly with breakdowns for key elements such as counterparty type, collateral type, maturity as well as haircut and fee ranges. Such an approach would only be effective after careful examination and coordination between regulators and market participants over the feasibility of aggregating various types of data.

The JFMC also supports greater transparency in corporate disclosures. However, we are concerned that the proposal to include information in financial statements of financial institutions regarding the details of securities lending and repo transaction might easily be misinterpreted by the broader financial markets, where a deep understanding of the repo markets is not necessarily a given, and this might in turn have a destabilising effect. We believe that other standard setting organisations, such as the IASB and FASB, which are both working on corporate disclosure, might be best situated to come up with specific recommendations for the appropriate amount of corporate disclosure regarding securities lending and repos.

7. Conclusion

In finalising the proposals we believe it is important that the impact on the wider market is judged and we are supportive of the FSB conducting a Quantitative Impact Study and clarifying some of the concepts in the paper. The JFMC would be happy to work with the FSB in ensuring that financial stability issues in these markets are effectively addressed. We would also be happy to provide any further information on any of the comments above.

Yours faithfully,

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