40 Broad Street
New York, NY 10004-2373
Telephone 212.440.9400
Fax 212.440.5260
www.bondmarkets.com

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456

St. Michael's House, 1 George Yard
London EC3V 9DH England
Telephone 44 20 77 43 93 00
Fax 44 20 77 43 93 01

THE BOND MARKET ASSOCIATION

May 30, 2001

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel
Switzerland

Ms. Kim Olson
Assistant Vice President
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045-0001

Mr. Oliver Page, Esq.
Chairman of the Capital Group
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Federal Reserve Board
Basel 2001 Capital Proposal
Mailstop 179
21st and C Streets NW
Washington, DC 20551

Basel 2001 Capital Proposal
Office of the Comptroller of the Currency
Mailstop 3-6
250 E. Street SW
Washington, DC 20219

Ladies and Gentlemen:

The Bond Market Association (the "Association")[1] appreciates the opportunity to comment on the proposed New Basel Capital Accord (the "Proposal").

Our members include financial institutions that are major participants in the securities financing markets, and in particular actively engage in repurchase ("repo"), securities lending and margin financing transactions. This letter provides our comments regarding the impact on such transactions of the Credit Risk Mitigation provisions of the Proposal, and primarily addresses those provisions in the Consultative Document entitled "The Standardised Approach to Credit Risk" (the "Standardised Approach"). This submission

[1] The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. The Association's member firms are actively involved in the funding markets for such securities, including the repurchase agreement and securities lending markets. Further information regarding the Association and its members and activities can be obtained from our web site (www.bondmarkets.com).

is intended to supplement the Association's preliminary comments as set out in our initial comment letter, dated May 2, 2001 (the "Initial Comment Letter").[2]

While the Association understands the desire of the Committee to finalize the Proposal by the end of 2001, it is increasingly becoming apparent that such goal may be impossible to reach given many of the completely new or incomplete concepts set out in the Proposal.[3] This is particularly so in light of the fact that, as discussed in more detail below, the Proposal as currently drafted does not accurately reflect the low-risk nature of funding transactions, and may have the unintended consequence of increasing systemic risk. Given the potential effect of the Proposal, the financial industry and the Committee should continue their dialogue regarding the Proposal beyond the May 31, 2001 deadline, and, if necessary, past the year end deadline the Committee has set for finalizing the Proposal. It is clear that further discussion between the Committee and the industry is required to ensure that the final Proposal accurately captures the actual economic risks of the financial institutions it is designed to regulate, and has the intended neutral effect upon actual capital requirements for this industry. To the extent provisions in the Proposal undergo substantial revision, the Committee should publish interim drafts of the Proposal for industry comment, even if the year end deadline for finalizing the Proposal is not met. In this regard, the Association stands ready to continue to provide the Committee with input from our member firms regarding the Proposal.

Of particular importance to the Association is the issue of application of the credit risk mitigation aspects of the Proposal to trading book activities of financial institutions. In certain jurisdictions that have implemented the current Accord, such as Europe through the Capital Adequacy Directive, funding transactions are treated as trading book activities. We understand that the Committee intends to provide further guidance on the issue of counterparty risk in the trading book in the form of an interim paper. The Association feels strongly that all elements of the Proposal applicable to the banking book should not automatically be applied to the trading book without a great deal of careful review and consultation with the industry. Funding transactions underpin a considerable degree of liquidity in the securities markets generally and it is important that the Committee avoid magnifying any unintended adverse consequences on market liquidity through application of the Proposals in their present form to trading book activities without any adjustment. Were the Committee to decide to apply the Proposal to funding transactions in the trading book, the Association strongly recommends providing national regulators broad latitude in approving risk-based models for determining capital requirements for such transactions.

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[2] Please also note that, under separate cover, the Association will submit a comment letter regarding the Proposal's impact on asset securitization.

[3] For example, the Association received a letter dated May 24, 2001 from the Financial Services Authority (FSA) asking for industry input regarding how the netting of funding transactions should be addressed in the Proposal. While we commend the FSA for their foresight in calling attention to this important issue, this letter demonstrates that netting of funding transactions is not addressed in the Proposal, and evidences the fact that it is still a work in progress. The incomplete nature of the Proposal is further demonstrated by the pending publication of an interim paper by the Committee to address counterparty risk in the trading book.

EXECUTIVE SUMMARY

Repo, securities borrowing and lending and margin lending transactions are critical to the financing and efficient functioning of the securities markets, and employ a high level of credit risk mitigation practices. The daily volumes for these transaction types are enormous.[4] Nonetheless, losses from credit or operational exposures have been nominal. In the main, the securities supporting these transactions are traded in highly liquid markets providing market valuations throughout the course of the trading day. Supporting significant sectors of these markets are centralized clearance facilities and common systems for the transfer of information. Financial institutions mitigate credit and operational risks through the rigorous application of daily procedures for the evaluation and transfer of collateral to cover unsecured exposures and by common reliance on industry-recognized documentation.

We commend the Committee for making such a significant effort to more closely align regulatory capital requirements with economic risks, while also seeking to minimize the effect on the overall level of capital financial institutions must hold. However, we are concerned that, in the repo and securities lending markets, these goals will not be achieved if the Proposal is adopted in its present form. In our view, the Proposal does not sufficiently take into account the safety, liquidity and sound risk management practices that are characteristic of these markets. The resulting effect of the Proposal would be a regulatory scheme that does not reflect the low level of risk in funding transactions, and substantially increases capital costs for certain funding transactions. This effect runs contrary to the stated goal of the Proposal to "deliver a more risk-sensitive standardized approach that on average neither raises nor lowers regulatory capital for internationally active banks" (Paragraph 7 of the Overview of the Proposal). Given the integral role funding transactions play in providing liquidity to the financial markets, the Proposal will adversely impact such liquidity by raising the regulatory costs of engaging in funding transactions. This adverse impact on liquidity will increase the potential for systemic risk.

The Association respectfully submits the following comments in order to address these concerns. A summary of our comments on the relevant portions of the Proposal are set out below:

1. Generally, we:

   - **Support** the stated goals of the Accord to more closely align regulatory capital requirements with actual economic risk, without effecting an increase in aggregate regulatory capital requirements.

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[4] Data from primary dealers in the United States which report to the Federal Reserve Bank of New York show that the average daily volume of total outstanding repo agreements alone was $2.53 trillion in 2000, an increase of 4.2% from 1999. In Europe, total repo and securities lending transactions settled on one settlement platform (Euroclear) amounted to 95 trillion EUR in 2000.

- **Express significant concern** that the Proposal does not properly recognize the low-risk nature of repo, securities lending and margin lending transactions.

- **Express significant concern** that aspects of the Proposal would impose significant additional regulatory capital costs, as well as impair liquidity, in connection with repo, securities lending and margin lending transactions.

- **Urge** the Committee to consider the adverse effect the Proposal may have on maintaining and encouraging sound risk management practices and on the liquidity and stability of securities markets.

2. On the methodology, level and application of collateral haircuts, we **<u>request that</u>**:

   - The calculation and level of haircuts in the Proposal be substantially revised to properly reflect economic risk levels.

   - Financial institutions be permitted to determine their own haircuts by using internal models of risk calculation.

   - Correlations between securities taken in as collateral and transferred out be recognized for purposes of calculating more accurate haircut levels, and haircuts be reduced where transactions are part of a "matched book."

   - The 10-day liquidation assumption for calculating haircuts be reduced to a more appropriate 3 or 4 days.

   - The Proposal clarify that "liquidation" of collateral occurs upon the acceptance of the offer to sell the collateral or "buy-in" securities.

3. On the *w* factor, we **<u>request that</u>**:

   - The *w* factor be eliminated.

4. On netting, we **<u>request that</u>**:

   - The Proposal permit the netting of repo, securities lending and margin lending transactions as a credit risk mitigant in determining capital charges for credit risk.

   - Haircuts be applied to the net amount of the exposure.

   - Netting be permitted where it is legally effective under master agreements.

   - Cross-product netting be appropriately recognized and encouraged under the Proposal.

5. On the government repo-style carve-out, we:

- **Commend** the Committee's recognition that repo-style transactions should be exempt from the *w* factor and from haircuts.

- **<u>Request that</u>** the carve-out be expanded to recognize a wider range of collateral and transactions.

6. On collateral eligibility requirements, we **<u>request that</u>**:

   - Financial institutions be able to recognize any collateral eligible for inclusion in their trading account.

   - A number of clarifications regarding the risk weighting of cash collateral be adopted.

7. On the legal recognition of collateral, we **<u>request that</u>**:

   - The requirements for the legal recognition of collateral more closely conform to actual market practice.

<u>COMMENT</u>

Background

Repurchase transactions ("repos") and securities loans developed along with the growth of U.S. and international debt and equity markets.[5] As recognized in a recent report, "securities lending is an integral component of nearly all active securities markets, both domestic and international."[6] Repo and securities lending transactions are important to the liquidity and growth of the broader financial markets because they greatly reduce obstacles, such as lack of funding or inability to access needed securities, that many financial institutions would otherwise face when engaging in securities transactions. Ready accessibility to these markets allows financial institutions to finance and hedge their securities positions in an economically efficient, effective, and low-risk manner, as well as to structure flexible trading strategies. In addition, these transactions are frequently utilized by financial institutions because of the flexibility they provide, their operation within a robust legal framework, the high level of market discipline they employ, and the historically low losses associated with such transactions. The liquidity such transactions provide plays an important role in the prevention of increased systemic risk.

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[5] Recent estimates from twelve countries show that the value of repo transactions conducted with government securities alone averaged close to $200 billion (Technical Committee of the International Organization of Securities Commissions (IOSCO), *Securities Lending Transactions: Market Development and Implications*, July 1999).

[6] *Ibid*.

Such transactions increase the liquidity of the broader securities markets by allowing financial institutions to borrow securities on a short-term basis, reducing the potential for failed settlements. In this manner, financial institutions "are able to obtain needed securities by borrowing or by reverse-repos, without an undesirable effect on their inventory management."[7] Many financial institutions also borrow securities to hedge their exposures in offsetting positions they have taken on through derivative instruments. In addition to increasing liquidity in the financial markets, hedging allows financial institutions to further mitigate their risk.

Financial institutions also often act as intermediaries between ultimate borrowers and suppliers of funds, combining repos and reverse repos and securities borrowings and loans into a "matched book." Matched book trading provides another source of funding to a broad range of financial market participants and is indispensable in providing market liquidity for the underlying securities involved in these transactions. Other common forms of repo transactions involve the delivery of funds against securities (a "delivery-versus-payment" or "DVP" transaction). Such DVP transactions are generally much easier to enter into than other forms of secured financing, increasing the appeal and flexibility of such transactions. As such, DVP transactions further facilitate liquidity in the broader financial market by providing funding counterparties a flexible and secured method of obtaining securities and financing.

An overarching appeal of securities lending and repo transactions is their low-risk nature. This low level of risk is a product of effective credit risk mitigation practices, a high degree of market discipline, sophisticated market participants and systems, robust and well-tested legal documentation and a sound legal foundation developed over a period of years. The availability of a flexible yet tested and secured method of borrowing funds greatly reduces the need for financial institutions to use unsecured (and therefore riskier) financing options. Additional risk mitigation is provided through daily revaluation of collateral, or "marking-to-market," by the right to swift re-margining of such collateral in the event of an undercollateralized exposure, and by the ability of counterparties to close out of a transaction promptly in the event such additional margin is not provided. In addition, master agreements provide a robust legal framework for these funding transactions. Such master agreements provide for prompt termination in the event of a default under the agreement (*e.g.*, failure of a counterparty to provide additional margin). The generally short-term nature of funding transactions, many of which are entered into only for an overnight period, also reduces the level of risk.

The low-risk nature of such transactions is demonstrated through the low levels of loss such transactions have historically generated. Internal analyses by many of our members have shown that losses in the repo and securities lending markets have been insignificant over the last decade.

As a result of these advantages that repo and securities lending transactions offer to financial market participants, the use of such transactions has experienced significant

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[7] Bank for International Settlements, *Market Liquidity: Research Findings and Selected Policy Implications*, May 1999.

growth over the past decade. As recently stated by one BIS Committee, "the growth of securities lending [including repo transactions] is attributable in large measure to the positive effects securities lending has had on both investment activity and securities settlement arrangements."[8]

The following credit risk management practices are standard in these markets:

- Daily marking-to-market of contracts to determine net exposures: Trading positions and collateral are marked-to-market on a daily basis to ensure that a counterparty's exposure is adequately collateralized.

- Daily re-margining to eliminate any net exposures: In the event the daily marking-to-market process detects an undercollateralized exposure, a party has the right to call for margin on a same day or next-day basis and margin is required to be delivered on short notice to promptly eliminate such collateral deficit.

- Netting: Counterparties to a funding transaction offset their exposures vis-à-vis one another in order to reduce the amount of exposure one counterparty has to the other. Such netting reduces systemic risk, as it allows a financial institution with a defaulting counterparty to crystallize its exposure and set-off amounts it owes to the counterparty against the counterparty's obligations. In addition, netting provides added protection to the financial institution by reducing its total exposure to an insolvent counterparty. [9]

- Use of master agreements: Standard master agreements have been adopted in virtually every major jurisdiction. The widespread use of agreements such as The Bond Market Association/International Securities Market Association Global Master Repurchase Agreement has helped to foster sound risk management practices for these transactions. Such agreements:

  (1) give the non-defaulting party the right to close-out all transactions under the agreement upon an event of default, including in the event of bankruptcy of the counterparty;

  (2) allow for prompt liquidation of collateral upon an event of default;

  (3) generally give the non-defaulting party or a disinterested third party custodian the right to determine, in good faith, the valuation of securities and collateral even where there is no generally recognized market quotation available;

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[8] *Securities Lending Transactions*, July 1999.

[9] Netting of such transactions receive special treatment under U.S. bankruptcy law. Certain secured creditors may be prevented from quickly liquidating collateral because of the "automatic stay" provisions of the Bankruptcy Code, which impose a halt to liquidation while a bankruptcy trustee determines the priority of each creditor's claim against the insolvent entity. Note, however, that the U.S. Bankruptcy Code provides counterparties to repo and securities lending transactions protection from such automatic stay provisions in the event they are deemed to be a creditor of an insolvent entity. The U.S. laws that govern insolvencies of banks that are not subject to the Bankruptcy Code contain similar protections.

(4) provide for the netting of gains and losses on transactions closed out under a master agreement so that a single net amount is owed by one party to the other; and

(5) are legally enforceable under applicable law, including in the event of the bankruptcy of a counterparty.[10]

In addition, the proliferation of third-party clearing organizations and tri-party custody arrangements has further reduced the level of risk in funding transactions. The development of robust multilateral clearing houses that novate and net exposures (such as the Government Securities Clearing Corporation and the National Securities Clearing Corporation in the U.S.) reduce counterparty risk by ensuring a common creditworthy counterparty and reducing the level of exposure through multilateral netting. The development of soundly managed domestic and international securities clearing systems for prompt settlement of securities through book-entry (such as Euroclear, Clearstream, and the Depository Trust Corporation) further reduces risks involving the operational and settlement aspects of funding transactions. And, in triparty custody arrangements, independent third party custodian banks conduct the valuation, mark-to-market and margin transfer functions, and effect the daily transfers of securities and collateral between the parties' accounts at the bank, thereby minimizing external transfers of cash and securities, and systemic risk.

As discussed in detail below, failure of the Proposal to incorporate capital charges that properly reflect the low risk factors in these transactions would serve as a disincentive to sound risk management practices and could have the unintended effect of encouraging banks to engage in higher risk activities.

Adverse Market Effect of the Proposal

The Association believes that there are aspects of the Proposal, as currently drafted, that could adversely impact funding transactions and the liquidity such transactions provide to the broader securities markets by raising the costs of engaging in such transactions. Analyses by several of our members suggest that the Proposal will result in significantly higher capital costs in certain of these transactions than under the current rules. Comparisons to the current risk-based capital rules in the United States demonstrate that, under the current Proposal, the risk-weight percentages for collateral used in funding transactions will dramatically increase, thereby greatly increasing the regulatory capital costs of engaging in such transactions.

Given the prospect of such higher regulatory costs, the Association is concerned that the level of dealer activity in the funding markets could decrease under the Proposal, leading

[10] The Association, as well as other organizations such as the International Securities Market Association (ISMA) and the International Securities Lenders Association (ISLA), have gathered opinions on certain master agreements published by such organizations in several jurisdictions to evidence the enforceability of such agreements in the event of a bankruptcy of a counterparty.

to reduced liquidity in securities markets. The effect of such reduced liquidity would likely be felt, not only in sovereign debt markets, but by many other markets as well, including the markets for corporate debt, public-sector entity debt, mortgage and asset-backed securities, and equities. Clearly, such an outcome would be contrary to the Committee's intent to provide a more risk-sensitive regulatory structure while not increasing or decreasing the total regulatory cost for financial institutions.

The increase in regulatory capital costs is particularly inappropriate given the historically low levels of risk associated with these types of transactions, as evidenced by the low rates of loss such transactions have historically demonstrated. This outcome directly contradicts the stated goal of the Proposal to more closely align regulatory capital requirements with actual economic risk.

By increasing the costs of engaging in most repo and securities lending transactions, the Proposal will not only reduce liquidity in financial markets, but may also increase systemic risk by, in effect, discouraging the use of such low-risk funding transactions. The smooth functioning of repo and securities lending markets is crucial in allowing financial institutions to meet their obligations to deliver either cash or securities in the broader financial markets, particularly in market stress situations. The imposition of additional costs on these transactions would reduce the liquidity such transactions provide, and thus would potentially magnify the impact of a future market stress situation.

Collateral Haircuts (Paragraphs 86-100 of the Proposal)

As noted in our Initial Comment Letter and restated below under the heading "Expansion of Government Repo-Style Carve-Out," we believe that haircuts should not be applied to those funding transactions or margin lending transactions that are entered into with certain counterparties, employ a high level of credit risk mitigation practices, and involve liquid collateral. However, even for those funding transactions or margin lending transactions where haircuts would continue to apply under our proposed formulation, we believe the proposed calculation methodology and levels of haircuts set out in the Proposal are inappropriate.

The Association applauds the Committee for allowing financial institutions to internally determine collateral haircut values, regardless of whether such institution follows the standardized approach or the internal ratings based approach of the Proposal.[11] The Committee should clarify that the ability to determine haircut levels is open to any bank that is able to create supervisory-approved risk calculation models, regardless of whether such bank is subject to the 1996 Amendment to the Capital Accord to Incorporate Market Risk (the "Market Risk Amendment"). In addition, the methodology used in such models to determine haircut levels for funding transactions should vary in some respects from the

[11] The Standardized Approach states, "a bank's choice between standard supervisory and internal haircuts is independent of the choice it has made between the standardised approach and the foundation IRB approach to credit risk" (Paragraph 129).

internal models approach of the Market Risk Amendment. As set out below, certain assumptions the Market Risk Amendment employs in its calculation methodology do not accurately reflect actual funding market practices. Such practices, in many instances, mitigate credit risk to a greater degree than contemplated under the Market Risk Amendment methodology. Therefore, an approach that simply carries over all aspects of the Market Risk Amendment internal models approach to determine haircut levels for funding transaction collateral would not adequately reward these robust risk mitigation practices, and could actually provide a disincentive to continue to employ and further improve such practices.

One example of how the Market Risk Amendment approach may discourage improved credit risk mitigation practices is the 10-day market movement assumption used to calculate haircut levels. Instead of encouraging the rapid liquidation commonly employed in the funding markets, such 10-day assumption would discourage the prompt liquidation of collateral. Funding market participants would not have an important capital-related incentive to reduce risk by liquidating collateral more rapidly, since they would be required to employ a haircut that assumes a lengthy liquidation period. The liquidation assumption does not therefore reflect the low-risk and prompt liquidation often employed in funding transactions and may actually discourage such credit risk mitigation practice. Such 10-day assumption should therefore be reduced for the calculation of the prescribed haircuts under the Standardized Approach. In addition, financial institutions should be allowed to use a reduced liquidation period assumption in their calculations of haircut levels under the Proposal.

Both the standard supervisory and internally calculated haircuts for funding transaction collateral should instead be calculated based on a much shorter liquidation period, no more than 3 or 4 days. Integral to the low-risk nature of funding transactions is the ability of counterparties to promptly close out of the transaction and liquidate collateral. Unlike other collateralized financial transactions, liquidation can typically be effected in a funding transaction in 3 to 4 days, and often in less than 2 days. Thus, we strongly recommend that any haircuts be determined using this shorter liquidation assumption.

The Committee should also clarify that “liquidation” of a position is deemed to occur as of the time a liquidating party enters into a contract with a new counterparty to sell or purchase the securities. Financial institutions, both in the funding markets and the broader securities markets, view securities as having been liquidated at the time parties agree to purchase and sell such securities, not at the time proceeds are received for such sale. The Proposal should make clear that it intends to follow this prevailing market definition of “liquidation” in determining the length of the liquidation period assumption.

The high level of proposed haircuts also appears to presume a “double risk event,” e.g. the risk that the provider of collateral will default in addition to a sudden fall in the value of the collateral. Such risk is small in funding transactions, particularly because the vast majority of such transactions continue to use highly rated foreign sovereign debt or other collateral that exhibits the same qualities as the securities loaned or sold. Given the very small risk of a double risk event occurring, such low level of risk should not be reflected

at all in the haircuts. If a double risk event is to be reflected at all in the haircut values, such haircuts should be calibrated to reflect the very remote possibility of a double risk event occurring in a funding transaction.

The excessiveness of the haircut levels in the Proposal is further evidenced by the fact that they are generally higher than regulatory haircut levels applicable to both banks and other financial institutions that hold such securities as part of their inventory.[12] This is particularly difficult to understand given that risks are lower where securities are held as collateral (i.e., the unlikely "double risk event" scenario must occur in order to have a loss) than where they are held as outright inventory. Haircuts applied to securities collateral should be lower in order to reflect this lower level of risk.

Further, haircuts should not be applied in an additive manner to both sides of a funding transaction. Imposing haircuts on both the securities sold under a repo (or lent in a securities lending transaction) and the collateral received discourages sound collateralization practices. By applying haircuts on each side of a funding transaction in an additive fashion, the Proposal incorrectly assumes a complete negative correlation between securities loaned and the collateral given. In practice, there is frequently a positive market correlation between the securities sold or lent and the securities collateral taken in, and a lack of positive correlation between the issuer of the securities collateral and the collateral provider. Financial institutions engaging in these transactions often have developed models to enable them to take such correlations into account. In addition, such models are frequently used in creating value-at-risk (VaR) models, which themselves are examined by regulators in allowing financial institutions to determine their own haircut levels under the Market Risk Amendment. There is no reason why the use of such correlations should not similarly be allowed under the Proposal. We therefore request that haircut levels under the Proposal, as applied to funding transaction collateral, should recognize such correlations to further encourage sound collateral management practices.

The imposition of haircuts on both sides of a funding transaction has a particularly adverse impact on financial institutions that run a "matched book" and serve an important intermediary role between a lender and ultimate borrower of funds. Financial institutions running a matched book "reverse in" securities collateral and "repo out" such collateral. By acting as both a purchaser and seller of the same securities, such financial institutions would have haircuts applied on the same collateral twice in an additive manner. The application of haircuts in this manner does not take into account the fact that if a counterparty failure causes the financial institution's failure to perform the "matched" contract, the closeout amount owed to the institution should be the same or very similar on both sides of the "matched" transaction. By receiving this closeout amount, the

[12] For example, the maximum level of haircuts on similar instruments mandated for broker-dealers in the United States by the Securities and Exchange Commission is 15%; the most commonly used debt instruments have a haircut of between 0% and 9%. Comparisons cannot be readily made to the Capital Adequacy Directive (CAD) given its calculation of general market risk charges on a portfolio basis. However, even assuming a worst case scenario for the calculation of such haircuts, the haircut levels under CAD are still lower than those proposed under the Proposal, sometimes by as much as 14%.

financial institution is able to largely mitigate or eliminate the loss they would have otherwise incurred. The Proposal does not recognize the reduced risk matched-book transactions present; on the contrary, it presents a punitive structure by applying haircuts twice on the same collateral utilized by the financial institution in its matched book transactions. Instead, as noted above, the Proposal should recognize the positive correlations between the "reversed-in" and "repoed-out" collateral for purposes of applying more accurate, risk-sensitive haircuts to the collateral.

Funding transactions employ a number of credit risk mitigation practices to ensure the prompt liquidation of collateral. Such practices include daily marking-to-market and re-margining. In the event of an undercollateralized exposure, master documentation gives a financial institution the right to immediately close out of a funding transaction and liquidate collateral where additional margin is not provided on a timely basis. These credit risk mitigation practices have proven to be effective, as demonstrated by the historically low levels of loss experienced by the funding markets. The methodology and levels of collateral haircuts for funding transactions in the Proposal should reflect the ability of parties to such transactions to quickly close out in the case of increased unsecured exposure.

W **Factor (Paragraphs 84 and 101 of the Proposal and Paragraphs 153-157 of the Standardised Approach)**

The Association very strongly believes that the *w* factor should be eliminated from the Proposal. It is unclear which risks *w* is intended to represent that are not already dealt with elsewhere in the Proposal. In addition, as discussed below, and as recognized by the Committee in formulating the repo carve-out provision, many of the risks *w* may potentially represent are not applicable to funding transactions because of the low level of risk involved in such transactions:

- The *w* factor is not sensitive to any specific risk, but is applied across all funding transactions regardless of the credit risk mitigation techniques employed. The *w* factor will apply regardless of the quality of the collateral obtained, the frequency with which such collateral is revalued and additional margin provided, and the ability to close out and liquidate collateral quickly. The *w* factor does not therefore encourage these or other risk mitigation practices, and may actually encourage parties to be more lax in applying such practices, thereby increasing risk.

- Assuming *w* is intended to represent documentation risk, *w* is inappropriate for funding transactions because, as stated above, funding transactions are generally governed by well-established, legally enforceable master documentation. The funding markets recognize the legal stability of repo and securities lending transactions by pricing such transactions without building in a legal-risk component for transactions conducted under such master documentation, and employing common credit risk mitigation practices. Although some litigation risk remains even where there is

legally enforceable documentation, such risk exists in any kind of commercial transaction.

- If *w* is intended to provide a cushion for valuation and liquidation difficulties in the event of market shocks, the combination of daily marking-to-market, daily margining rights and robust legal documentation is designed to target and minimize these very risks. In particular, documentation governing such transactions typically contains provisions which allow the non-defaulting party or a third-party custodian flexibility in obtaining a reasonable market quote or otherwise determining market value for purposes of pricing and liquidating collateral in a funding transaction, even during periods of general market illiquidity. All other potential market risks regarding the collateral are captured in the haircut calculations.

- If the *w* factor is intended to represent a "double risk event," e.g., the combined risk that the provider of collateral will default and there will be a sudden drop in the value of the collateral, this risk (to the very limited extent it exists in funding transactions), is already addressed elsewhere in the Proposal. As noted above, such risk is minimal in funding transactions, particularly because the vast majority of such transactions continue to use highly rated sovereign debt or other collateral that exhibits the same qualities as securities sold or loaned. Any residual risk of a "double risk event" occurring is more than adequately captured through collateral haircuts and the credit risk weighting of a counterparty in respect of net exposure.

As noted above, these markets are characterized by disciplined and effective risk mitigation practices. Notwithstanding periods of market turbulence and illiquidity over the last five years, losses on these products have been insignificant. As noted in a recent BIS Committee report, "repo markets. . .are often relatively resilient and subject to limited credit rationing in periods of market turbulence."[13] Applying a blunt instrument such as *w* to these markets seems contrary to the Committee's stated goal to deliver a more risk-sensitive methodology that neither raises nor lowers overall regulatory capital for financial institutions and motivates financial institutions to improve their risk management practices.

Netting (Paragraphs 112-116 of the Proposal)

The Association has recently received a letter, dated May 24, 2001, from the Financial Services Authority (FSA), asking for industry input as to how netting of funding transactions should be addressed in the Proposal. The Association applauds the foresight shown by the FSA in calling attention to this issue, particularly given the fact that netting of funding transactions is not currently addressed in the Proposal. The Association will provide more detailed comments in response to the May 24 letter in the near future.

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[13] *Collateral in Wholesale Financial Markets: Recent Trends, Risk Management and Market Dynamics*, Committee on the Global Financial System, Bank for International Settlements (March 2001).

However, in an effort to respond by the May 31 deadline, we present below our preliminary comments on netting of funding transactions.

As stated in our Initial Comment Letter, the Association believes that the netting provisions of the Proposal should apply to funding transactions for a number of reasons. Most importantly, the netting of exposures between counterparties reduces the level of exposure one counterparty has to another. The resulting reduction of risk also decreases the cost of engaging in such transactions. In the context of the funding markets, such reduced cost has the potential to allow counterparties to enter into additional transactions, which in turn adds to the liquidity of the financial markets as a whole. As noted above, netting also reduces the likelihood of systemic risk, as it allows a financial institution with a defaulting counterparty to crystallize its exposure and liquidate only that collateral which is required to meet the net exposure.[14]

In addition, the Association believes it is important for the Proposal to address the significant disparity that exists today among different jurisdictions in respect of the recognition of effective netting agreements in the capital treatment of funding transactions. Under the national regulations implementing the current Basel Accord and national accounting rules, comparable master securities lending and repo transactions receive quite different capital and netting treatment in different jurisdictions despite the fact that funding transactions are increasingly international. Most notably, the EC Directives and the United Kingdom Financial Services Authority permit the calculation of exposures on trading book repo/reverse repo and securities lending/borrowing transactions on a portfolio basis, with collateral maintained on the exposure on a net basis. In the United States, by contrast, the capital treatment of these transactions follows on-balance sheet treatment under generally accepted accounting principles ("GAAP"); under U.S. GAAP, only limited forms of collateral are recognized and netting is permitted only in very limited circumstances.[15] Therefore, under the current U.S. regime such transactions generally cannot benefit from the current Accord, which recognizes netting only for off-balance sheet items.

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[14] See footnote 9.

[15] Under Financial Accounting Standards Board Interpretation No. 41, a bank may offset amounts recognized as a receivable under reverse repos if:

(1) the repo and reverse repo agreements are executed with the same counterparty;
(2) the repo and reverse repo agreements have the same settlement date;
(3) the repo and reverse repo agreements are executed with a master netting arrangement;
(4) the underlying securities exist in "book entry" form and can be transferred only by means of entry in the record of the transfer system operator or securities custodian;
(5) the repo and reverse repo agreements are settled on a securities transfer system, and the bank has associated banking arrangements in place;
(6) the bank intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (a) the cash inflows resulting from the settlement of the reverse repo and (b) the cash outflows in settlement of the offsetting repo.

Capital regulations regarding netting should provide incentives to engage in prudent netting practices, and should not necessarily follow the accounting treatment of netted exposures (as is the case in the United States). The Proposal can promote this objective by recognizing net credit exposures whether the transactions are regarded as on-balance sheet or off-balance sheet, or both, or are held in the banking book or the trading book. Haircuts, if applied, should relate to this net exposure. The haircut applied should be based on the average haircut applicable to the collateral.

The repo and securities lending markets have developed master agreements that provide for close out of positions and netting of exposure in the event of default. These agreements are legally effective in the event of bankruptcy in most, if not all, major jurisdictions. More favorable capital treatment of netting would actively encourage financial institutions to enter into such sound documentation for reducing risks. One suggested approach to more actively encourage netting is to allow for legal standards for netting that more closely follow actual market practice standards. Such standards include allowing netting for funding transactions where parties have a reasonable basis for concluding that the netting or offsetting of the netting agreement is enforceable in each relevant jurisdiction.

The Proposal should also recognize the reduction in credit exposures that can be achieved through legally effective cross-product master agreements. In February 2000, the Association published the Cross-Product Master Agreement (CPMA) jointly with eight other international trade associations. The CPMA is supported by legal opinions for the U.S. and the U.K., and the Association, in collaboration with other trade associations, is in the process of obtaining additional legal opinions to confirm the enforceability of this documentation, including in bankruptcy, in a substantial number of other major jurisdictions. Based on its own research, the Association respectfully disagrees with the Committee's statement in the Standardized Approach that "the legal enforceability of cross-product netting agreements is not considered to be sufficiently well tested in many jurisdictions to warrant recognition" (Paragraph 176). We urge the Committee to encourage the further development of such important risk mitigation efforts by according recognition to their true benefits.

Expansion of Government Repo-Style Carve-Out (Paragraphs 102-105 of the Proposal)

We commend the Committee for recognizing the very low risk associated with these products by carving out certain repo and securities lending transactions both from the *w* factor and from haircuts under the Standardised Approach. As noted above, the Association believes that, given such low risk, the haircut levels are inappropriately applied to funding transaction collateral, and that the *w* factor should be completely eliminated from the Proposal. The application of haircuts and the *w* factor to funding transactions that meet certain criteria is particularly inappropriate, and a carve-out from those rules is warranted.

As noted above, the effectiveness of credit risk mitigation techniques employed in funding transactions is evident in the low level of losses associated with such transactions. In addition, whether collateral used in funding transactions consists of sovereign debt securities or other types of collateral, such collateral often shares characteristics of sovereign debt, such as price transparency, liquidity, and settlement through a central clearing system.

In addition to the low levels of loss which funding transactions have historically demonstrated, such transactions should also be exempt from haircuts and the *w* factor given their central role in providing liquidity to the financial marketplace. Unlike other collateralized transactions, funding transactions play a crucial role in providing such liquidity. Given this important role, the imposition of additional costs on such transactions increases the risk of reduced liquidity, and is therefore unjustified.

The Association therefore believes that, given the important role funding transactions play in the broader financial market, the carve-out for such transactions should be broadened. Such broadened carve-out should be based *both* on the use of risk mitigation techniques and on the type of collateral used in such transactions. As presently drafted, the carve-out would only apply to a very narrowly defined category of "domestic transactions." The unfortunate effect of the carve-out, as currently drafted, is to penalize many other funding transactions that employ equally robust credit risk management practices and involve liquid securities collateral, such as exchange-listed equities. This creates a disincentive for market participants to adopt or maintain comparable practices for a wider range of transactions. The newly imposed costs may also serve to foster riskier trading practices with higher margins. Further, as noted above, with higher capital costs for dealer funding, the liquidity of the securities markets is likely to be adversely affected.

We therefore recommend that the carve-out in Paragraph 102 and 103 of the Proposal be expanded to include securities loans and repos in any securities that are "eligible collateral" under Paragraphs 76 to 79 of the Proposal or are otherwise appropriate to include in a financial institution's trading account.

The carve-out should also be available to securities lending or repo transactions whether they are conducted purely in a domestic market or internationally. Securities that settle in any settlement system approved and regulated by such settlement system's local national regulator or which otherwise routinely settle in such system should be included in the carve-out.[16]

Specifically, to qualify for the carve-out:

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[16] We recognize that a haircut for cross-currency exposures may be appropriate. However, the proposed uniform haircut of 8% does not take sufficient account of the correlation between certain currency values and the increasingly standard use of sophisticated correlation analysis to determine the appropriate currency haircut.

(1) the transaction would have to be marked-to-market daily;

(2) the transaction would have to be subject to daily remargining;

(3) both the exposure and the collateral would have to be "eligible collateral"[17] or instruments otherwise appropriate to include in the trading account;

(4) the collateral would have to be capable of being liquidated in no more than 4 business days;

(5) the transaction would have to involve securities that are settled in a settlement system approved and regulated by such settlement system's local national regulator or which otherwise routinely settles such securities;

(6) the transaction would have to be transacted under a master agreement that gives the nondefaulting party, upon the occurrence of an event of default, the right to promptly close out all transactions and liquidate collateral to establish a net settlement amount owed by one party to the other;

(7) the master agreement would have to be legally enforceable, including in the event of the insolvency of the counterparty (the standards of legal enforceability would be the same as those currently applied to netting agreements for off-balance sheet items under the current Basel Capital Accord); and

(8) the master agreement would have to be between "core market participants" (as defined in Paragraph 104 of the Proposal) or between any other counterparties in respect of which the agreement is legally enforceable, including in the event of their insolvency.

A funding transaction that satisfies the foregoing requirements should be subject to minimal risk of loss. Cross-border transactions, employing what is becoming increasingly standard domestic and international documentation, should qualify for the carve-out.

For similar reasons, the carve-out should also extend to margin loans that 1) involve "core market participants" (including both foreign and domestic "core market participants"), or any other counterparties in respect of which the agreement is legally enforceable, including in the event of their insolvency, 2) are collateralized by eligible collateral that can be liquidated in no more than 4 business days, 3) are marked-to-market daily, 4) are subject to daily remargining, 5) involve securities which are settled in a settlement system approved and regulated by such settlement system's local national regulator or which otherwise customarily settles such securities, 6) are covered by documentation specifying that if the counterparty fails to satisfy an obligation to deliver

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[17] Note that, as described herein, the Association advocates the expansion of criteria for "eligible collateral" set out in the Proposal. Such "eligible collateral," as expanded, should be allowed in funding transactions eligible for the carve-out.

margin when due or otherwise defaults, the transaction is immediately terminable and the collateral may be liquidated, and 7) are subject to legally enforceable documentation, including in the event of bankruptcy of the counterparty. As long as these criteria are met, the risk profile of these transactions is not substantively different from that of “government repo-style” transactions and thus should be subject to the same capital treatment. Moreover, this treatment would provide a continued incentive for market participants to use effective legal documentation and other sound risk mitigation practices in margin lending.

Exempting low-risk transactions from the costs imposed by the *w* factor and the haircuts would provide an important financial incentive for the continued proliferation of sound risk-management standards in the funding markets. As discussed above, the Association shares the view of many of its fellow trade associations that the *w* factor is conceptually flawed and should ideally not be included in the Proposal. We believe a floor capital charge is particularly inappropriate for funding transactions that meet the criteria listed above.

Eligible Collateral (Paragraphs 76-79 of the Proposal)

Financial institutions should be permitted to recognize as eligible collateral in a repo, securities lending or margin lending transaction any securities eligible to be included in the trading book.

In addition, the list of “eligible collateral” should be expanded to include cash collateral irrespective of whether it is held “on deposit with the lending bank.” Cash otherwise held by a collateral agent such as a third-party financial institution or custodian should be considered eligible collateral. The risk weight for cash collateral held by a financial institution for its own account should be 0%. Further, cash collateral held by a third-party custodian for a financial institution should also have a risk-weight of 0% where such financial institution’s claim in respect of the cash collateral would rank ahead of other creditors of the custodian in the event of its insolvency. Otherwise, cash collateral held by a third-party custodian should have the risk weight of such third-party custodian.

Legal Recognition of Collateral (Paragraphs 68-71 of the Proposal)

The legal requirements that the Proposal sets forth for the recognition of collateral do not conform to industry standards and practices. These standards and practices are embodied in financial institutions’ internal policies regarding the accepted documentation and procedures for obtaining a security interest (or equivalent rights) over various types of collateral in a number of jurisdictions. For example, while the Proposal would make legal opinions mandatory, under current practice a financial institution may not in all cases seek a formal internal or outside legal opinion confirming its legal position, particularly where short-term credit exposures and liquid collateral such as cash and

securities are involved. More commonly, a financial institution satisfies itself that it has a reasonable basis to conclude that it has a full title transfer, first priority security interest or equivalent unencumbered interest in the collateral. Where an opinion is obtained, it is normally updated when the applicable law is known to have changed, rather than at pre-determined regular intervals.

In addition, in multijurisdictional transactions where collateral may be held through a number of custodians and subcustodians, financial institutions consider the type of collateral, applicable choice of law rules, likely location of enforcement actions, and similar factors that provide a reasonable basis for them to reach the judgment that their rights in the collateral will be recognized in the event of default of the counterparty (including potential insolvency). We believe the legal requirements for recognition of collateral in the Proposal should more clearly reflect these rigorous industry standards of collateral management. Accordingly, we recommend that Paragraphs 68-71 of the Proposal be revised as follows:

Legal Certainty

68. Collateral is effective only if the legal documentation and requisite procedural steps have been taken which give the secured party:

    (a) ownership of the collateral subject to an obligation to return equivalent collateral, where the return obligation can be set-off against the secured obligation; or

    (b) rights in and to the collateral which are recognized, in the event of default by the debtor and in the event of the debtor's insolvency, in priority to rights of the debtor and of creditors of the debtor (other than liens or similar rights arising by operation of law).

69. A bank must have conducted sufficient legal review to have a reasonable basis to conclude that the foregoing requirements are satisfied and should have an internal process for assuring the requirements continue to be met in the event of changes in applicable laws.

70. The foregoing legal analysis should appropriately take into account multijurisdictional aspects, if any, of the collateral arrangements.

71. Where collateral is held by a custodian or by a financial intermediary, the contractual arrangements should provide that the collateral is held in such manner that it should not become part of the general assets of the custodian or intermediary in the event of the insolvency of the custodian or intermediary (customary liens of a central depository or clearing system are permissible).

CONCLUSION

The Proposal, as currently drafted, will greatly increase costs on certain funding transactions, without providing an incentive to maintain or improve upon existing robust credit risk mitigation practices. In addition to contradicting the stated goals of the Proposal, this result is also inappropriate given the low level of risk associated with such transactions, as evidenced by the low rate of loss such transactions have historically demonstrated. The Proposal should be revised to reflect more accurately the low level of risk such transactions actually present, and to achieve the stated goal of the Proposal not to increase the regulatory costs of engaging in such transactions.

While the Association commends the Committee's decision to allow financial institutions to internally determine haircut levels, it respectfully requests that the Committee clarify its position to state that financial institutions that create supervisory-approved risk calculation models be allowed to employ their own haircut levels. In addition, financial institutions should be allowed to calculate their haircut levels based on a reduced liquidation holding period consisting of 3 or 4 days at the most. The definition of "liquidation" should also be clarified to mean the time at which a trade is arranged to liquidate collateral.

In addition, the *w* factor should be eliminated. It is unclear what risks *w* is intended to represent. Regardless, given the low level of risk in funding transactions (as proven by the low level of loss such transactions have demonstrated), any risk *w* is intended to represent is either adequately captured in the level of haircuts, or is inapplicable to funding transactions given the credit risk mitigation practices such transactions employ.

Netting of exposures, while commonly employed as a risk mitigation practice in funding transactions, is not encouraged in the Proposal, since it does not appear to be addressed at all. The Proposal should set out guidelines for the netting of exposures in funding transactions effected pursuant to master agreements, and encourage additional risk mitigation practices, such as cross-product netting. If haircuts are applicable to such funding transactions, they should be applied on the net exposure.

While the Association believes that *w* should be eliminated from the Proposal across the board, and that haircut levels applied generally to funding transactions are excessive, it further believes that both haircuts and the *w* factor are particularly inappropriate for

funding transactions that meet certain criteria. Those funding transactions that employ a high level of credit risk mitigation techniques, quality collateral, and involve creditworthy counterparties, should not be subject to haircuts or the *w* factor. This is particularly true given the increased risk of illiquidity in the financial markets that is presented if the regulatory costs of engaging in funding transactions increases.

In addition to the provisions of the Proposal that deal with regulatory capital requirements, other provisions, such as the legal recognition of collateral and criteria for eligible collateral should be revised to more closely track actual market practice.

We hope the foregoing is helpful to you as you consider further refinements of the Proposal. We look forward to continued dialogue among the Association, our individual members and the Committee. Should you have any questions concerning this letter, please do not hesitate to contact me at 212.440.9474 or ooztan@bondmarkets.com.

Sincerely,

/s/ Omer Oztan

Omer Oztan
Assistant General Counsel
The Bond Market Association

Joined by:

/s/ Godfried De Vidts

Godfried De Vidts
Chairman
ISMA European Repo Council
Associate Money Market
Product Manager
Fortis Bank

Cc: Norah Barger, *Federal Reserve Board*