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THE BOND MARKET ASSOCIATION

May 2, 2001

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

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 play an active role in the securities financing markets, and engage in repurchase ("repo"), securities lending and margin financing transactions. At the request of members of the Basel Committee on Banking Supervision (the "Committee"), this letter provides our preliminary comments regarding the impact on such transactions of the Credit Risk Mitigation provisions of the Proposal and the Consultative Document entitled "The Standardised Approach to Credit Risk" (the "Standardised Approach").

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

[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).

active banks" (Paragraph 7 of the Overview of the Proposal). The Proposal, if adopted, could adversely affect the funding markets and therefore the liquidity of the securities markets more broadly.

As noted above, this letter is submitted in response to the request of members of the Capital Group of the Committee that we communicate our views on key aspects of the Proposal as early in the comment process as possible. The Association intends to file a final letter prior to the close of the official comment period that will provide further detailed comments on the Proposal as it relates to the funding markets.[2]

Repurchase transactions ("repos") and securities loans developed along with the growth of U.S. and international debt and equity markets.[3] By providing a source of funding for participants in the financial markets as well as a mechanism for hedging dealer exposures, these products have played a vital role in the growth of these markets. Such transactions have become essential tools used to fund a financial institution's day-to-day operations and financial positions. 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," providing another source of funding to a broad range of financial market participants and facilitating market liquidity for the underlying securities involved in these transactions. Thus, these products are indispensable in providing liquidity to the broader financial markets.

The Association believes that there are aspects of the Proposal, as currently drafted, that could adversely impact these crucial activities. 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. This result is inconsistent with the historically low levels of risk associated with these types of transactions and could result in a reduced level of dealer activity, leading to reduced liquidity in securities markets. Clearly, such an outcome would be contrary to the Committee's intent in setting banking organization regulatory capital requirements.

We note that historically these markets have been reliable and resilient. This excellent track record has been the 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. As a result, losses in the repo and securities lending markets have been insignificant. The generally short-term nature of funding transactions, many of which are

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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] 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).

often entered into for an overnight period, also reduces the level of risk involved in such transactions.

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 which novate and net exposures (such as the Government Securities Clearing Corporation and the National Securities Clearing Corporation) reduce counterparty risk by ensuring a creditworthy counterparty and reducing the level of exposure through 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.

Specifically, the following 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-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.

- 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;

(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.

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. The Association believes that funding transactions that employ sound risk mitigation techniques should not be subject to the *w* factor or haircuts. As noted above, the effectiveness of such techniques is evident in the low level of losses experienced in funding 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.

The Association therefore believes that the carve-out for funding transactions 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 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 settled in a “foreign settlement system” should be included in the carve-out if such securities routinely settle in such system.[4]

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[4] 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

Specifically, to qualify for the carve-out:

(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"[5] 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, including a "foreign settlement system," that customarily settles securities of that type;

(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

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and the increasingly standard use by financial institutions of sophisticated correlation analysis to determine the appropriate currency haircut.

[5] 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.

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 that customarily settles securities of that type, 6) are covered by documentation specifying that if the counterparty fails to satisfy an obligation to deliver 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 further discussed below, 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.

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

The Association believes that the *w* factor should be eliminated from the Proposal. As an initial matter, it is unclear which risks *w* is intended to represent that are not already dealt with elsewhere in the Proposal. In addition, as discussed above, 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:

- 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. 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 and robust legal documentation adequately mitigates such risks.

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. 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.

Collateral Haircuts (Paragraphs 86-100 of the Proposal)

For those funding transactions that are subject to collateral haircuts, the levels of such haircuts are excessive, particularly because such haircuts are based on a 10-day liquidation assumption. Liquidation can typically be effected in a funding transaction in 3 to 4 days. Such rapid liquidation should be encouraged in the Proposal. (Moreover, the Committee should clarify that "liquidation" of a position should be determined as of the time a liquidating party enters into a contract with a new counterparty to sell or purchase the securities.) Thus, we recommend that any haircuts be determined using this shorter liquidation assumption.

Further, 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. The imposition of haircuts on both sides of a funding transaction has a particularly adverse impact on financial institutions which run a "matched book" and serve an important intermediary role between a lender and ultimate borrower of funds.

We also note that the Proposal applies the haircuts to each side of a funding transaction in an additive fashion, assuming statistical independence between the securities loaned and the collateral given. However, in practice, there is frequently a high market correlation between securities sold or lent and the securities collateral. Financial institutions engaging in these transactions often have developed models to enable them to take such correlations into account. The haircuts should reflect such correlations to further encourage sound collateral management practices.

Eligible Collateral (Paragraphs 76-79 of the Proposal)

Financial institutions that have obtained supervisory approval to use their value-at-risk models for market risk-based rules (or the internal ratings-based ("IRB") approach) to calculate their own haircuts should be able to recognize any collateral to which such value-at-risk models apply.

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 because it meets the stated criteria in Paragraph 110 of the Standardised Approach. 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.

Netting (Paragraphs 112-116 of the Proposal)

It is unclear whether the netting provisions of the Proposal are intended to apply to funding transactions. The Association believes that netting provisions should apply to such transactions for a number of reasons. The netting of exposures between counterparties reduces the amount 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.

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 GAAP, only limited forms of collateral are recognized and netting is permitted only in very limited circumstances.[6] Therefore, under the current U.S. regime the

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[6] 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;

transactions generally cannot benefit from the current Accord, which recognizes netting only for off-balance sheet items.

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.

Further, 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.

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. We urge the Committee to encourage the further development of such important risk mitigation efforts by according recognition to their true benefits.

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

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(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.

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).

We hope the foregoing is helpful to you as you consider further refinements of the Proposal. We look forward to providing you with further written comments before the close of the formal comment period, and we also 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
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