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# COMMITTEE ON SECURITIES LENDING

June 28, 2013

Via e-mail

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

**Re: Supervisory Framework for Measuring and Controlling Large  
Exposures**

Dear Sir or Madam:

The Committee on Securities Lending (the “RMA Committee”) of the Risk Management Association (the “RMA”) appreciates the opportunity to submit this letter to the Basel Committee on Banking Supervision (the “BCBS”) on behalf of several of its members, including The Bank of New York Mellon, Citigroup, Credit Suisse, Northern Trust Company, State Street Corporation and other financial institutions that participate in the securities lending industry as securities lending agents (“Agent Banks”) on behalf of their clients.<sup>1</sup> This letter addresses the BCBS consultative document (the “Consultative Document”) on a supervisory framework for measuring and controlling large exposures.<sup>2</sup>

<sup>1</sup> Although most securities lending agents are structured as banks, lending agents may also include investment managers, broker-dealers, and other legal entities. The focus of this letter, however, is on the impact of the Consultative Document on banks. The RMA Committee acts as a liaison for RMA member institutions involved in agency lending functions within the securities lending industry by providing products and services, including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

<sup>2</sup> BCBS, *Supervisory framework for measuring and controlling large exposures* (Mar. 2013), available at <http://www.bis.org/publ/bcbs246.pdf>.

As the BCBS is aware, Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides for the application of single-counterparty concentration limits (“SCCL”) to large banking organizations and nonbank financial companies determined to be systemically important.<sup>3</sup> In December 2011, the Federal Reserve Board (the “Board”) issued proposed rules to implement the SCCL (the “Board Proposal”), in response to which the RMA Committee provided extensive comments (the “April 2012 Comment Letter”).<sup>4</sup> The Consultative Document and Board Proposal are fundamentally similar in underlying principles and objectives, in that both seek to address prudential limits on counterparty exposure, and thus any limit based on the Consultative Document has the potential to cause similar market impacts to the Board Proposal.<sup>5</sup> In this regard, we estimated in our April 2012 Comment Letter that application of the SCCL as currently contemplated by the Board could decrease securities on loan at U.S. Agent Banks by up to 30% to 50%, and we believe similar impacts could result from any exposure limit based on the Consultative Document.<sup>6</sup> Because of the fundamental similarities between the two proposals, the interrelationship between international and domestic frameworks and the significant potential for disruptive market impacts, the RMA Committee is providing comments to the BCBS on the Consultative Document.

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<sup>3</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, § 165(e), 124 Stat. 1376, 1427-28 (2010).

<sup>4</sup> Letter from the RMA Committee, to the Board (Apr. 30, 2012), *available at* <http://www.rmahq.org/File%20Library/Securities%20Lending/Regulatory%20-%20Legal/RMA-Comment-Letter---Enhanced-Prudential-Standards.pdf>.

<sup>5</sup> We note, however, that the Consultative Document and Board Proposal differ in key respects. For example, the Consultative Document provides for a more stringent definition of capital against which the exposure limit would be calculated.

<sup>6</sup> See April 2012 Comment Letter, *supra* note 4, at 7.

### **Executive Summary**

- Agency securities lending is a traditional, safe and sound activity that supports global capital markets activities. Agent Banks in the majority of cases provide a securities replacement guarantee, more commonly known as borrower default indemnification, to securities lending clients, which creates the exposure (with respect to the borrower) for purposes of any single exposure limit.

#### *Exposure Calculation Methodology*

- The RMA Committee strongly believes that internal models are the most appropriate methodology for calculating exposures from agency securities finance transactions. These models, used for capital calculations and risk management, use Value-at-Risk approaches to take into account risk-mitigating factors such as asset correlation and therefore ensure that calculated exposures are proportional to their actual risk.
- To the extent the BCBS is unwilling to support the use of internal models, then to address BCBS concerns the RMA Committee recommends an alternative approach based on models with supervisory inputs. Under this approach, supervisors would provide haircuts, correlations between loaned and borrowed securities and collateral and specific risk adjustments, thereby ensuring full regulatory visibility and comparative consistency across institutions.
- The RMA Committee strongly believes that a models-based approach, whether based on institution-specific or supervisory inputs, is the most appropriate methodology for calculating exposures from agency SFTs. If, however, the BCBS continues to favor a haircut-based methodology, then the RMA Committee submits that exposure calculations for agency securities finance transactions should at a minimum incorporate a published “matrix” of haircuts developed by supervisors that takes into account risk-mitigating benefits of correlations between positions.

#### *Control Determination*

- “Control” should be defined as: (i) owning, controlling, or having the power to vote more than 50% of voting securities of an entity; and (ii) consolidation of the entity for financial reporting purposes.

#### *Calculation Components*

- In order to remain consistent with current approaches in individual jurisdictions, any large exposure limits should be measured against total regulatory capital rather than Common Equity Tier 1 or Tier 1 capital.

### *Covered Entities*

- The RMA Committee supports the exclusion of sovereigns from the limit, but is still concerned that the “hybrid” approach to financial collateral is overly punitive, because it requires banking organizations to shift collateralized exposures to the collateral issuer and assumes multiple simultaneous defaults that are unlikely to occur.

### *Timing*

- The BCBS should not recommend a more stringent limit for any class of institutions, including entities designated as global systemically important banks by the Financial Stability Board.
- To the extent any large exposure regime is implemented, either on an international basis or in the United States as part of the SCCL framework, such a regime should not become fully effective until January 1, 2019.

## **I. Background on Agency Securities Lending Activities**

Agency securities lending is a traditional, safe and sound activity that supports global capital markets activities and facilitates trade settlement.<sup>7</sup> Supervisors have long recognized the importance of securities lending to financial markets and the overall macroeconomy. For example, the BCBS has found that securities lending markets are a “vital component of ... domestic and international financial markets, providing liquidity and greater flexibility to securities, cash and derivatives markets,” and the Financial Stability Board (the “FSB”) has found that agent lenders play an important role by helping beneficial owners access “economies of scale, securities lending expertise and

<sup>7</sup> Securities lenders use agency securities lending services from agent banks in order to obtain additional incremental revenues. Agency securities lending activities developed initially as an outgrowth of agent banks’ custody and related activities, and have long been regulated, examined and treated by regulators as traditional banking services. *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for the growing securities lending industry); Letter from J. Virgil Mattingly, General Counsel, Board, William F. Kroener, General Counsel, Federal Deposit Insurance Corporation, and Julie L. Williams, General Counsel, Office of the Comptroller of the Currency (“OCC”), to the Securities and Exchange Commission (Dec. 10, 2002) (indicating that interagency guidelines “ensure that banks conduct their securities lending activities in a safe and sound manner and consistent with sound business practices, investor protection considerations and applicable law”); Bank of England, Securities Lending and Repo Committee, Securities Borrowing and Lending Code of Guidance (July 2009) (describing how securities lending transactions are regulated both under UK regulations and EU directives), *available at* <http://www.bankofengland.co.uk/markets/Documents/gilts/stockborrowing.pdf>; Directive 2004/39/EC, of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

systems . . . specialized market knowledge and better access to borrowers.”<sup>8</sup> Securities lending increases global market liquidity and enhances price discovery by expanding the amount of securities available for financial activities. Most securities lenders are financial institutions, such as public and private pension funds, sovereign funds, central banks, insurance companies, collective investment schemes such as undertakings for collective investment in transferable securities (“UCITS”) funds, and similar funds or entities. Securities borrowers largely consist of banks, broker-dealers and other financial institutions.

Agent Banks act as intermediaries in securities lending programs by facilitating loans on behalf of securities lenders to qualified borrowers. Securities are generally lent pursuant to a (i) securities lending authorization agreement between the securities lender and the agent bank, and (ii) securities borrowing agreement between the borrower and the agent bank. Under these agreements, the borrower provides collateral to the securities lender (and generally, via its agent bank) in excess of the value of the loaned securities, usually by 2% to 12% depending upon the characteristics of the loaned securities and the collateral. The loan is then marked to market daily to ensure that the collateral consistently meets the requisite excess value.

To provide protection to lending clients and demonstrate confidence in its program, Agent Banks in the majority of cases provided a securities replacement guarantee, more commonly known as borrower default indemnification (“Indemnification”), to the lending client. The Indemnification creates the Agent Bank’s “exposure” (with respect to the borrower) for purposes of the large exposure limit. Given that securities lending transactions are considered a safe and sound method for a lending client to obtain incremental revenue from its securities portfolio, the Indemnification is considered critical and in fact is legally or contractually required by many securities lenders. For the reasons discussed below, if the Consultative Document is finalized as proposed, Agent Banks may need to dramatically reduce their Indemnification to clients like UCITS funds, pension plans, government plans, and central banks or reduce their indemnified lending volume in order to satisfy the exposure limits.

A diagram showing the structure of a typical securities lending transaction is attached as Exhibit A. According to Data Explorers, a securities lending data service, approximately 85% of securities loans in the U.S. market (when both the lender and borrower are in the U.S.) use cash as collateral, and in the European market, approximately 75% of securities loans use securities as collateral. Cash collateral is reinvested in securities, sometimes in collective investment vehicles or cash collateral pools. As of the first quarter of 2013, RMA data showed over \$969 billion of loaned

<sup>8</sup> See BCBS, *Securities lending transactions: market development and implications* (July 1999), available at <http://www.bis.org/publ/cpss32.htm>; FSB, *Securities Lending and Repos: Market Overview and Financial Stability Issues* 20-21 (Apr. 27, 2012), available at [http://www.financialstabilityboard.org/publications/r\\_120427.pdf](http://www.financialstabilityboard.org/publications/r_120427.pdf).

securities globally. RMA composite figures, compiled using responses of 13 member institutions, reflected \$6.73 trillion of U.S. lendable assets and \$3.54 trillion of non-U.S. lendable assets in the securities lending market for the first quarter of 2013. Of those assets, over \$462 billion of U.S. securities and \$147 billion of non-U.S. securities were on loan against cash collateral.<sup>9</sup> Assets on loan remain substantially below peak levels achieved prior to the financial crisis. Based on data publicly disclosed in agent lender 10-Qs, as of March 31, 2013 loan balances have declined by over 50% since March 31, 2008, despite significant appreciation in major equity market indices during that same time period.

As discussed in detail below, the RMA Committee's primary concern is that the Consultative Document disfavors the use of internal models to calculate exposures from agency securities finance transactions ("agency SFTs") for purposes of the large exposure limit. As we discussed in a recent comment letter to the U.S. Federal banking agencies regarding implementation of the Basel III capital framework in the United States, the RMA Committee believes strongly that internal models are the optimal approach to calculating exposures from agency SFTs, as they allow Agent Banks to use sophisticated analyses to calculate exposures that are closely reflective of the actual risks associated with these transactions.<sup>10</sup> Using internal models that take into account risk mitigating factors such as asset correlation ensures that exposures associated with agency SFTs are proportional to their actual risk. Indeed, because the Consultative Document would not permit the recognition of correlations between positions, the Consultative Document actually penalizes safe and sound behavior by Agent Banks.

The RMA Committee is concerned that if individual jurisdictions follow the Consultative Document's recommendations with respect to the disallowance of models, the result will be a significant decrease in overall market liquidity. As noted, supervisors have long been aware that agency SFTs enhance market efficiency and provide an important source of liquidity to the securities markets,<sup>11</sup> and a number of studies have shown that reduced supply of agency SFTs would reduce liquidity in the broader market.<sup>12</sup> We urge the BCBS to remain cognizant of the recognized efficiency and

<sup>9</sup> RMA Quarterly Composite Data on Securities Lending, First Quarter 2013.

<sup>10</sup> Letter from the RMA Committee, to the Board (Oct. 19, 2012), *available at* <http://www.rmahq.org/File%20Library/Securities%20Lending/Regulatory%20-%20Legal/dpny-23731206-v7-RMA---Basel-III-Comment-Letter.pdf>.

<sup>11</sup> *See, e.g.*, Risk-Based Capital Guidelines; Market Risk Measure; Securities Borrowing Transactions, 71 Fed. Reg. 8,932, 8,933 (Feb. 22, 2006) ("Securities borrowing enhances market efficiency and provides an important source of liquidity to the securities markets.").

<sup>12</sup> *See, e.g.*, Pedro A.C. Saffi & Karl Sigurdsson, Price Efficiency and Short Selling 821-852 (Am. Fin. Ass'n New Orleans Meeting Paper) (2010), *available at* <http://ssrn.com/abstract=949027> (showing through an analysis of weekly data on share lending supply and borrowing fees from 26 markets that lending supply has a significant impact on efficiency, in that stocks with higher short-sale constraints,

liquidity benefits of agency SFTs, and to consider carefully any recommendations that could negatively impact these markets. We also urge the BCBS to consider supervisory approaches with respect to the use of models in other contexts, *e.g.*, derivatives, where supervisors have continued to permit the use of models while analyzing the feasibility of alternative approaches. We also address below the macroprudential concerns with agency SFTs that certain regulators have raised in speeches over the last several months to demonstrate why regulators should not seek to inhibit this activity.

In addition, we urge the BCBS to consider carefully how any large exposure limit will interact with other reforms to the regulatory framework governing agency SFTs, *e.g.*, implementation of the Basel III capital framework and changes in European regulations governing exchange-traded and UCITS funds. These reforms already represent a significant and fundamental shift in the regulation of agency SFTs, and care must be taken to ensure that any large exposure limit does not impose cumulatively negative impacts on the market.

Below, we offer our specific comments on the Consultative Document.

## **II. Measuring Exposures**

The Consultative Document recognizes that banking organizations have several options for measuring exposures from SFTs for regulatory capital purposes: (i) the “comprehensive” approach, pursuant to which a banking organization would use internal or supervisory estimates to calculate haircuts; (ii) using Value-at-Risk (“VaR”) models to calculate exposure on a counterparty-by-counterparty basis; and (iii) subject to supervisory approval, the internal models methodology. Despite the explicit recognition of different approaches to modeling, the Consultative Document declares that calculated exposures should “not be based on banks’ internal models,” and recommends that banking organizations use a comprehensive approach with supervisory haircuts to calculate exposures from SFTs.

### **A. Benefits of Models – Generally**

The RMA Committee strongly disagrees with the Consultative Document’s recommendations with respect to internal models, and believes such a wholesale rejection

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measured by low lending supply, have lower price efficiency). In addition, a number of studies have shown that constraints on short-selling negatively affect market liquidity, and given that short-selling is dependent on securities lending, it follows that a reduction in lending supply would reduce market liquidity. *See also* Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, Shacking Short Sellers: The 2008 Shorting Ban (2009), available at <http://ssrn.com/abstract=1412844> (showing through a study of spreads, price impacts, firm-level volatility and other data during the 2008 ban on short sales that shorting restrictions negatively impact liquidity and market quality); Douglas W. Diamond & Robert E. Verrecchia, Constraints on short-selling and asset price adjustment to private information, 18 *Journal of Fin. Econ.* 277-311 (1987) (predicting that if there are constraints on ability to sell securities short, prices will adjust more slowly to negative information).

of models-based approaches is inappropriate and unwarranted. As the BCBS is aware, supervisors permit Agent Banks to use specific types of internal models to calculate exposures from agency SFTs for regulatory capital purposes and these models are subject to robust audit, examination and oversight from supervisors.<sup>13</sup> This framework is well-established, and ensures that all aspects of the modeling process are understood by supervisors, but the Consultative Document appears to almost completely ignore these factors and inappropriately disfavors all internal models-based approaches to calculating exposures from agency SFTs.

The Consultative Document gives inadequate consideration to the benefits of internal models, which are particularly significant in the agency SFT context. Using internal models to calculate exposures from agency SFTs is clearly the most risk-sensitive approach, as well as the most feasible from an administrative and cost perspective, as Agent Banks already use them to calculate exposures for regulatory capital purposes.<sup>14</sup> As noted above, these models are reviewed and examined on a regular basis by regulators, auditors and management, and take into account sensitivity to the volatility of loan and collateral positions (and, in the case of non-cash collateral, reflect correlations between loaned and collateral securities), and therefore ensure that agency SFTs produce exposure calculations that are proportional to actual risk. By contrast, calculating exposures using supervisory haircuts as proposed in the Consultative Document is an overly blunt approach that does not incentivize risk-reducing behavior for portfolios of correlated loan and collateral positions.

We strongly urge the BCBS to consider carefully the benefits of models-based approaches, and to permit banking organizations to use these models when calculating exposures from agency SFTs for purposes of any large exposure limit. Internal models provide the most accurate calculations of exposures from agency SFTs, are validated via their historical use for capital calculations, would avoid negative impacts on overall market efficiency and liquidity and as discussed below, can be tailored to address any supervisory or prudential concerns while still preserving the significant benefits of this approach.

## **B. Supervisory Input Models**

We believe strongly that a models-based approach is the most appropriate and accurate methodology for calculating exposures arising from agency SFTs, but are aware of supervisory concerns relating to the transparency and comparability of models. While

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<sup>13</sup> See Board Letter to Gregory J. Lyons (Nov. 8, 2005); Board Letter to Gregory J. Lyons (May 14, 2003); OCC Interpretive Letter No. 1105 (Sept. 18, 2008); OCC Interpretive Letter No. 1066 (Nov. 8, 2005).

<sup>14</sup> While we focus on the use of models in the agency SFT context, models-based approaches would appear to be of equal benefit to securities finance activities as a whole.



we believe that the benefits of the models-based approaches far outweigh any costs associated with differences in model outputs among institutions, and believe that the robust existing oversight process obviates concerns with respect to model transparency, to the extent the BCBS is unwilling to support the use of internal models because of these concerns, we urge consideration of an approach where Agent Banks are permitted to use *models with inputs provided by supervisors, i.e.*, an approach where supervisors have complete discretion to set model inputs, and the *only* variation between individual models would arise from a firm's positions (the "Supervisory Inputs Approach"). Under the Supervisory Inputs Approach, supervisors would provide inputs to banking organizations, *e.g.*, haircuts, correlations between loaned and borrowed securities and collateral and specific risk adjustments. As discussed below, there are significant benefits to the Supervisory Inputs Approach, including (i) maintaining consistency and mitigating volatility of model outputs; (ii) better aligning exposure calculations with prudent risk management practices; and (iii) ability to leverage existing risk management platforms, thereby avoiding significant cost and administrative burdens associated with changes to systems infrastructure.

First, and as appears to be strongly desired, the Supervisory Inputs Approach would allow supervisors to enhance comparative consistency and reduce volatility. Because inputs would be determined by supervisors and made uniform across institutions, calculated exposures could be more easily compared to determine relationships between assumptions and outputs. The Supervisory Inputs Approach offers the flexibility to adjust inputs to take into account specific risks, "flights to quality" and market stress events. Such an approach would also be consistent with other elements of the supervisory framework that contemplate adjustment and calibration depending on market conditions; for example, the Basel III capital framework provides for the imposition of a countercyclical capital buffer when "the risks of system-wide stress are growing markedly."<sup>15</sup>

The Supervisory Inputs Approach would permit banking organizations to recognize the risk-mitigating benefits of correlations between and among asset classes, and thus would not penalize institutions for promoting prudent risk and exposure management practices. Although the Supervisory Inputs Approach would not have the same level of granularity with respect to correlations, it would still take into account correlations between and among asset classes, thereby more accurately reflecting exposures arising from agency SFTs while still achieving supervisory objectives of consistency, transparency and reduced volatility.

The Supervisory Inputs Approach also would reduce the amount of costly and administratively burdensome changes that would need to be made to existing systems and infrastructure. While banking organizations would still incur significant costs

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<sup>15</sup> BCBS, *Basel III: A global regulatory framework for more resilient banks and banking systems* 57 (Rev. June 2011), available at <http://www.bis.org/publ/bcbs189.htm>.

implementing a Supervisory Inputs Approach, they would incur far greater costs complying with a framework that prohibited the use of models. Many banking organizations have invested millions of dollars in systems for purposes of risk-based capital calculations, and a prohibition against the use of models would be inconsistent with these existing practices and require the construction of an entirely new and parallel infrastructure that would be used only for purposes of the exposure limit. Rather than imposing these costs on affected institutions, the RMA Committee urges the BCBS to consider a Supervisory Inputs Approach that addresses supervisory concerns and permits banking organizations to leverage existing infrastructure. The BCBS recognizes in the Consultative Document the importance of avoiding the needless imposition of costs on affected institutions, and the RMA Committee urges the BCBS to take a similar view in the context of its approach to calculating exposures from agency SFTs.

Finally, the RMA Committee is aware of recent speeches by regulators regarding the perceived systemic risks presented by SFTs, particularly with respect to the perceived volatility of SFTs as a short-term funding market vulnerable to “runs.”<sup>16</sup> We strongly disagree with the suggestion that properly conducted and structured agency SFTs present heightened risks to financial stability; to the contrary, agency SFTs are recognized as traditional, safe and sound activities that rarely produce significant losses to entities involved in the program and are unlikely to lead to systemic concerns. If nonetheless regulators wish to affirmatively address any perceived macroeconomic concerns, such concerns could be more than adequately addressed by the Supervisory Inputs Approach, which as discussed above allows supervisors to impose substantially similar haircuts across institutions, thereby ensuring that volatility in calculated exposures from agency SFTs would be mitigated and inputs could be appropriately calibrated and, if necessary, adjusted to take market stress into account. In sum, the RMA Committee believes that the Supervisory Inputs Approach would more than adequately address any perceived volatility or run risk arising from agency SFTs, and urges the BCBS to actively consider the merits of this approach.

### **C. Reasonable Haircuts Through A Multi-Dimensional Matrix**

The RMA Committee strongly believes that a models-based approach, whether based on institution-specific or supervisory inputs, is the most appropriate methodology for calculating exposures from agency SFTs. If, despite the above benefits, the BCBS continues to favor a haircut-based methodology, the RMA Committee submits that the BCBS should support the use of a multi-dimensional matrix of haircuts published by supervisors based on combinations of loaned securities and collateral received that reflects correlations between positions, and therefore more accurately reflects

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<sup>16</sup> See, e.g., Daniel K. Tarullo, Governor, Fed. Reserve Sys., Remarks at the Peterson Institute for International Economics: Evaluating Progress in Regulatory Reforms to Promote Financial Stability (May 3, 2013); Janet L. Yellen, Vice Chair, Fed. Reserve Sys., Regulatory Landscapes – a US Perspective, Speech at the International Monetary Conference (June 2, 2013).

counterparty exposure. While inferior to models-based approaches, a multi-dimensional matrix that takes into account correlations between positions should produce haircuts that more accurately reflect underlying risks and exposures associated with agency SFTs, allowing banking organizations to realize at least some of the benefits associated with correlations between positions. The RMA Committee stands ready to assist the BCBS with any necessary analysis needed to develop such a matrix.

### **III. Connected Counterparties and Definition of “Control”**

Similar to the Board Proposal, the Consultative Document provides that banking organizations should consolidate exposures to counterparties that are “connected,” *i.e.*, part of the same corporate group. Both the Consultative Document and the Board Proposal look to whether a “control” relationship exists between entities for purposes of this analysis, but take different approaches to defining “control.” The Board Proposal defines “control” as (i) owning, controlling or having the power to vote more than 25% of the voting securities of an entity, (ii) owing or controlling 25% of the total equity of an entity or (iii) consolidating the entity for financial reporting purposes.<sup>17</sup> The Consultative Document, on the other hand, defines “control” to exist (i) automatically, when one entity controls more than 50% of the voting rights of another entity and (ii) when one or more specific criteria are met, including voting arrangements or significant influence on the appointment or dismissal of management or supervisors. The Consultative Document also indicates that banking organizations should refer to criteria specified in accounting standards for additional guidance when determining whether control exists.

While the Consultative Document’s approach is preferable to the Board Proposal, the RMA Committee still submits further adjustment is appropriate. The RMA Committee believes that the primary purpose of deeming connected entities “controlled” for purposes of any large exposure limit should be to identify those entities that are under the operational control of the relevant corporate group and would look to the same source of funds for repayment of the exposure. To ensure that only entities meeting this test are deemed “controlled” for purposes of the Consultative Document, the RMA Committee suggests that “control” be defined to mean (i) owning, controlling or having the power to vote more than 50% of the voting securities of an entity; and (ii) consolidation of the entity for financial reporting purposes (*e.g.*, Generally Accepted Accounting Principles or International Financial Reporting Standards, as applicable).

### **IV. Capital Measure – Definition of Eligible Capital**

The Consultative Document proposes that the large exposures limit be based on a banking organization’s Common Equity Tier 1 (“CET1”) or Tier 1 capital, rather than “total regulatory capital, [] as is currently the case in many [BCBS] jurisdictions[.]” We see no policy reason to deviate from the approach of measuring the limit against total

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<sup>17</sup> 77 Fed. Reg. 649.

regulatory capital, as individual jurisdictions have appropriately recognized that the costs of an overly stringent definition of capital outweigh the benefits. We urge the BCBS to remain consistent with the reasoned analyses of individual jurisdictions, and base any large exposure limits on total regulatory capital rather than CET1 or Tier 1 capital.

#### **V. Treatment of Sovereign Obligations and Financial Collateral**

The Consultative Document excludes sovereign obligations from the large exposure limit, an exclusion that has broad application in the agency SFT context, as a significant percentage of transactions (particularly in Europe) involve the direct transfer of or are collateralized by local sovereign obligations. With respect to the treatment of financial collateral more generally, the Consultative Document recommends a “hybrid” approach, such that covered banking organizations would be required to (i) reduce calculated exposure amounts by the “post-haircut” amount of financial collateral; and (ii) apply the “substitution approach,” *i.e.* “treat the amount by which the exposure has been reduced due to the existence of collateral as an exposure to the issuer of the collateral in its own right.”

While we strongly support the exclusion of sovereign exposures from the limit, we are still concerned that the hybrid approach is overly punitive, as it requires banking organizations to “shift” collateralized exposures to the collateral issuer, and therefore assumes multiple simultaneous defaults of underlying obligors and collateral issuers that are unlikely to occur. The overly punitive impact of this treatment is particularly acute in the context of agency SFT transactions, which typically involve relatively short time frames, daily mark-to-market and margin maintenance and liquid, high-quality collateral, the value of which is often uncorrelated with the credit quality of individual counterparties. Moreover, because Agent Banks’ agency SFT portfolios are diversified by counterparty and collateral type, this approach implicitly assumes that an Agent Bank will face simultaneous defaults by multiple distinct counterparties, a highly unlikely proposition.

The hybrid approach creates particular issues for Agent Banks that utilize tri-party custodians to manage non-cash collateral. These Agent Banks will generally determine collateral eligibility based on factors such as indices, liquidity, and market capitalization, with defined issuer and issue concentration limits. Under the tri-party arrangement collateral may be substituted on a daily basis, meaning that the composition of the collateral can change. This dynamic shifting of collateral, which results in dynamic shifting of exposures under the hybrid approach, may make it difficult for these Agent Banks to monitor and comply with any limit.

The RMA Committee believes there are alternative approaches that address BCBS’s perceived concerns with respect to simultaneous defaults, while still recognizing the risk-mitigating benefits of a diversified portfolio of counterparties. One such approach is the introduction of binomial models of joint defaults for specific

counterparties, which could be adapted by the BCBS to distinguish among joint probabilities of default for global systemically important banks (“G-SIBs”), financial institutions, and non-financial counterparties. Such an approach would also take into account higher probabilities of joint default across longer liquidation time horizons. The RMA Committee stands ready and would be pleased to discuss this and other alternative approaches with the BCBS.

## **VI. Large Exposure Rules for Global Systemically Important Banks**

While the Consultative Document proposes a “baseline” large exposure limit of 25% of a banking organization’s CET1 or Tier 1 capital, both the Consultative Document and the Board Proposal provide for more stringent large exposures limits for the largest banking organizations, with the Consultative Document recommending a limit for exposures between G-SIBs of between 10-15% of eligible capital and the Board Proposal providing for a limit of 10% for exposures between banking organizations with \$500 billion or more in total consolidated assets.<sup>18</sup>

Consistent with previous comments on the Board Proposal,<sup>19</sup> we strongly oppose the imposition of a more stringent exposure limit on any class of covered institutions. The imposition of a “baseline” 25% limit in and of itself has the potential to cause significant disruption to Agent Banks (especially if the Consultative Document continues to disfavor the use of models), and we submit that the imposition of a more stringent limit has the potential to significantly magnify these disruptions without any demonstrated corresponding benefit. The significant potential for disruptions and the myriad significant rules involving large banks that are not finalized or implemented suggests that the BCBS should refrain from recommending a more stringent limit for any class of institutions until the regulatory reform process is further advanced, especially with respect to full implementation of the Basel III capital framework in the United States and Europe. If, however, the BCBS and the Board continue to recommend a more stringent limit for certain institutions despite these objections, such limits should not be uniformly stringent but should instead distinguish between individual counterparties based on the actual risks presented by that counterparty.

## **VII. Finalizing Transitional Arrangements and Implementation Time Frame**

The Consultative Document appropriately recognizes that banking organizations and supervisors will require time to transition to any new large exposures framework, and therefore recommends full implementation of the limit by January 1, 2019. The RMA

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<sup>18</sup> 77 Fed. Reg. 652.

<sup>19</sup> See Letter from the Clearing House Ass’n, the Am. Bankers Ass’n, the Fin. Servs. Forum, the Fin. Servs. Roundtable, and the Sec. Indus. and Fin. Mkts. Ass’n, to the Board (Apr. 27, 2012), *available at* [http://www.federalreserve.gov/SECRS/2012/May/20120501/R-1438/R-1438\\_042712\\_107270\\_542775340448\\_1.pdf](http://www.federalreserve.gov/SECRS/2012/May/20120501/R-1438/R-1438_042712_107270_542775340448_1.pdf).

Committee supports this approach, and believes that there are several bases for an extended transition period and implementation time frame for any exposure limit. First, the BCBS will need adequate time to analyze comments submitted by market participants and other stakeholders in response to the Consultative Document. Second, the BCBS is conducting a quantitative impact study (“QIS”) on the large exposures limit which apparently is based on data as of December 31, 2012 and therefore, as shown in Exhibit 2, understates banking organizations’ exposures from agency SFTs relative to averages throughout the calendar year. A new QIS may be justified with a measurement period that has positions more representative of typical exposures, and suggests that a longer evaluation period will be necessary for the BCBS and other stakeholders to accurately determine the effect of the limit on securities finance markets. Third, affected banking organizations will need adequate lead time to develop and implement any necessary changes to management information systems and other infrastructure, particularly if the final framework does not permit the use of internal models. In this regard, we note in particular that banking organizations could be required to undertake substantial changes to their trading books and associated operations to comply with any large exposure limit, and that such change may require substantial resources to complete.

Consistent with these ongoing initiatives and the need to provide for an adequate and appropriate transition and implementation period, the RMA Committee concurs with the BCBS, and recommends that to the extent any large exposure regime is implemented, either on an international basis or in the United States as part of the SCCL framework, such a regime not become fully effective until January 1, 2019.

### **VIII. Conclusion**

We thank the BCBS for the opportunity to comment on the Consultative Document and participate in the ongoing dialogue on exposure limits. We look forward to continued dialogue with the BCBS and other supervisors and believe, as the BCBS does, that achieving effective and efficient reform requires healthy and robust collaboration between supervisors and market participants. As the BCBS considers our comments and those of other market participants, we emphasize that effective regulation requires robust cost-benefit analysis and thorough consideration of whether perceived benefits of regulatory changes outweigh the costs imposed on individual firms and the overall economy. In this regard, we believe that the cumulative impact of the various recommendations in the Consultative Document, such as an overly stringent limit measured against CET1 or Tier 1 capital and the disallowance of models-based approaches, have the potential to significantly decrease the amount of securities on loan and negatively impact overall market liquidity. We submit that a holistic approach which sufficiently accounts for these cumulative impacts is required in order to create a large exposures framework that enhances the overall stability of the financial system, while still preserving the crucial economic and liquidity benefits of agency securities lending activities.

We encourage the BCBS to take the time to consider the proposals we have set forth in this letter. If desired by the BCBS, the RMA Committee would be pleased to discuss this letter in further detail, and stands ready to assist the BCBS as it continues to implement the large exposures framework.

Sincerely,

*Christopher R. Kunkle*

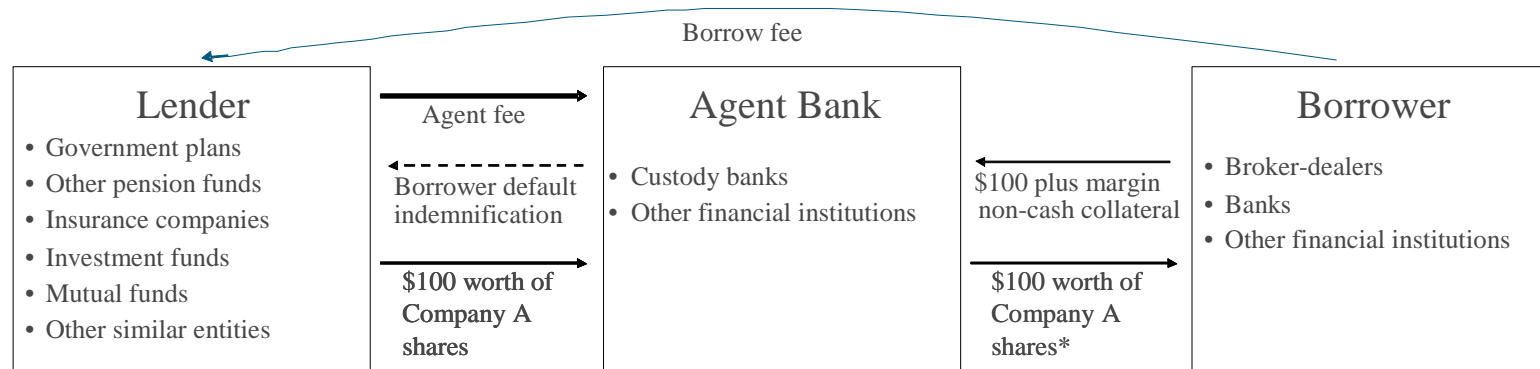
Director  
Securities Lending & Market Risk  
Risk Management Association

*Jason P. Strofs*

Chairman  
Committee on Securities Lending  
Risk Management Association

## **EXHIBIT A**

### **Typical Securities Loan Structure (Non-Cash Collateral)**

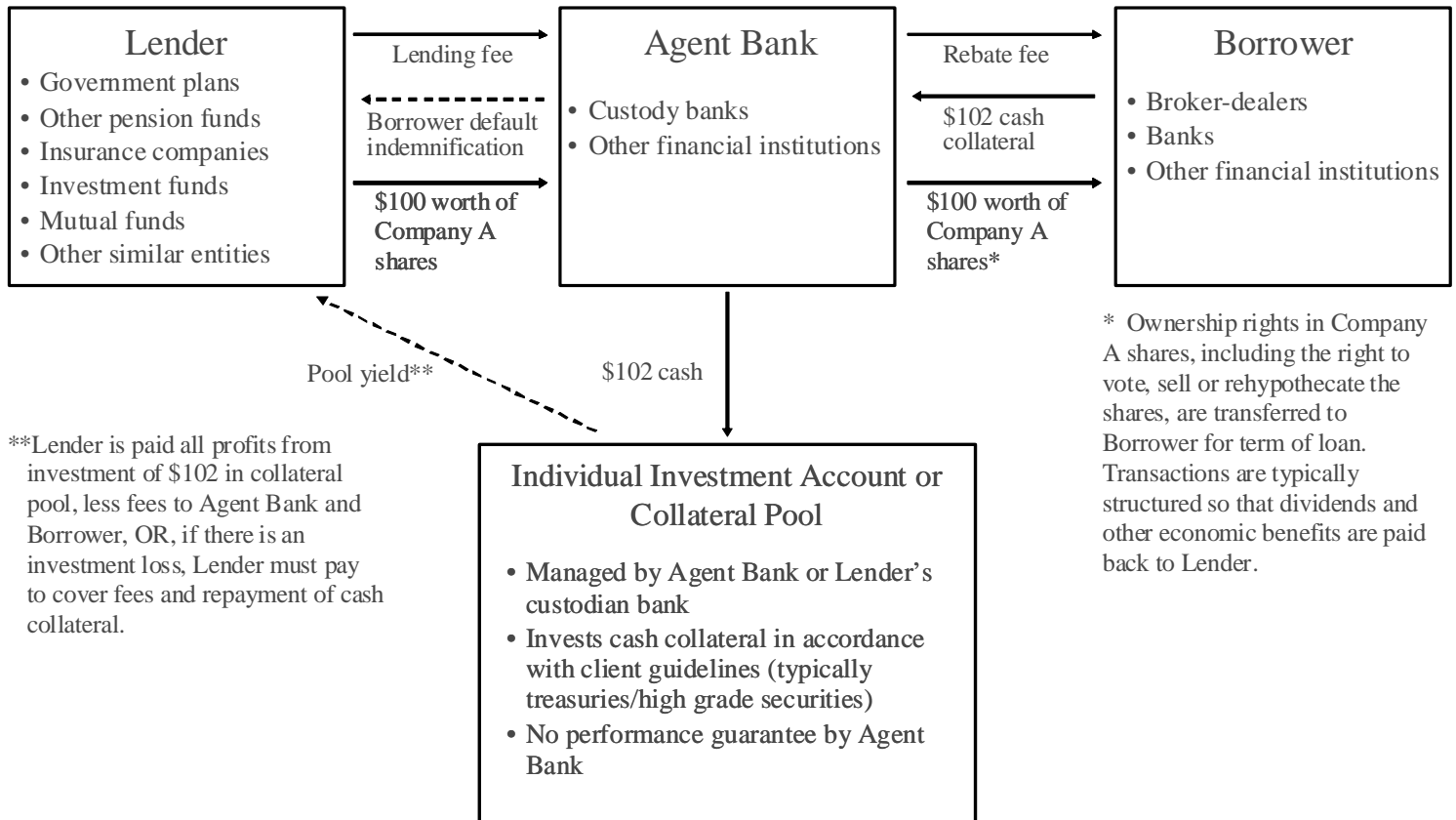


\* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.



## **EXHIBIT A**

### **Typical Securities Loan Structure (Cash Collateral)**



## EXHIBIT B

