The International Securities Lending Association
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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

20 September 2013

Revised Basel III leverage ratio framework and disclosure requirements

We are pleased to provide a response to the above consultation document on behalf of the International Securities Lending Association ("ISLA").

ISLA is a trade association established in 1989 to represent the common interest of participants in the European securities lending market. It has 90 members compromising insurance companies, pension funds, asset managers, banks and securities dealers. For more information please visit the ISLA website www.isla.co.uk

Background on securities lending

Securities lending is a technique employed by long term investors such as pension funds, insurance companies and mutual funds as a means of generating incremental returns on portfolios. Securities loans are fully collateralised and conducted within a well-established legal framework. Banks and prudentially regulated broker dealers provide the market for securities lending by acting as principal intermediaries, borrowing securities from long term investors and using or on-lending them for a variety of purposes, including facilitating market making and trading strategies such as covered short selling. Banks also act as agents on behalf of the investors that engage in securities lending and are therefore critical to the operation of this market. Securities lending activity is acknowledged as adding to secondary market efficiency which benefits all users of the capital markets. More specifically:-

- Long term investors in Europe alone generate around EUR3bn of revenues from securities lending activity each year.
- Securities lending provides an important source of liquidity to securities markets, allowing market makers and primary dealers (for government bonds) to make efficient two way markets for investors.
- Securities lending supports investment strategies employed by asset managers including arbitrage, hedging and short selling which are widely accepted as adding to market efficiency through provision of liquidity, lower relative volatility and more effective asset price discovery.
- Securities finance transactions ("SFTs") such as securities borrowing and lending, and repurchase and reverse repurchase agreements are the principal mechanisms for transferring collateral within the financial system. In the context of the debate around collateral scarcity we expect that these markets will be required to play an increasing role in ensuring that the market has access to suitable collateral.
- Central Securities Depositories use the securities lending market to cover imminent settlement fails helping to reduce systemic risk. (A large European ICSD has estimated that settlement fail rates could increase by as much as 100% if securities lending stopped).

More information on this market is available on the ISLA website and in the guide for investors "Securities Lending: An Introductory Guide"[1].

ISLA's Comments on the Proposed Framework

As always, we appreciate the opportunity to comment on the proposed framework. Given the focus of this association our comments are naturally restricted to the proposals for enhanced treatment of SFTs. Generally we have concerns that the proposed framework will result in banks being encouraged to significantly reduce SFT business and that this will have negative consequences. Our specific comments on the proposals are as follows:-

[1] http://www.isla.co.uk/images/PDF/Publications/sl_intro_guide_9_10.pdf

A. Inclusion of gross SFT assets in the Exposure Measure will have negative consequences for financial markets. Some allowance for netting would be consistent with the aims of the leverage ratio.

We note that the revised Basel III leverage ratio framework materially changes the calculation of the exposure measure for SFTs. Whilst we appreciate that the leverage ratio is designed to act as a simple, transparent and alternative measure to risk-based capital requirements we are concerned that measuring SFT exposures on a gross basis without any allowance for appropriate netting of transactions will disincentivise banks from undertaking securities lending and repo business. This will have negative consequences for financial markets by generally reducing liquidity in equity and bond markets, raising risks and costs for market making and primary dealing, constraining the movement of collateral within the financial system and reducing the valuable incremental revenues that long term investors receive from lending their securities. We believe that there is a legitimate case for the exposure measure to take account of netting SFTs and believe that there are a number of ways that this could be achieved. At very least we would support the proposals being put forward by the International Capital Market Association's European Repo Council ("ERC") that propose the netting of SFTs in certain circumstances when subject to legally enforceable netting agreements. Furthermore we support the arguments that they advance in support of netting of CCP cleared transactions. We believe that these proposals would be consistent with the policy objectives of the leverage ratio and would certainly help to alleviate the negative consequences of constraining SFT markets.

Our members share the view expressed by the ERC that the proposed framework for SFTs will result in the leverage ratio, rather than risk-based capital ratios, becoming the binding constraint on the ability of a large number of banks to conduct securities lending and borrowing, and repurchase and reverse repurchase transactions. SFTs, which are secured by liquid collateral, and conducted under master agreements supported by netting opinions (and which have withstood the defaults of major market participants), are generally considered to be lower risk transactions which result in correspondingly lower risk weighted measures.

Using the simple gross measure of exposure for SFTs will incentivise banks to do less of these collateralised, low risk transactions. It would appear odd that the leverage ratio framework, which we understand is designed to work in conjunction with the risk-based capital ratios, should discourage this type of activity. Whilst we have not been able to quantify the negative effects of the proposed treatment of SFT exposures our members believe that these will be material. We therefore urge the Committee to consider an alternative basis for the calculation of the SFT exposure measure to include an allowance for netting where appropriate.

B. The framework proposes a deduction for certain securities from Gross SFT assets but we would appreciate clarification as to what this is designed to cover.

Under 35(i) "..the value of securities received in an SFT and recognised as an asset by the transferor if the transferor has the right to hypothecate but has not done so." may be removed from the gross SFT assets. We would appreciate clarification that this point is intended to address securities recognised by a lender in a borrow pledge or securities for securities exchange.

C. The counterparty credit risk add-on (to gross SFT assets) appears inconsistent with the objectives of the leverage ratio.

The amounts calculated in the counterparty credit risk measure represent credit and liquidity risks and do not create leverage. Requiring these to be included in addition to gross SFT assets would appear inconsistent with the leverage ratios objectives.

D. Comment on s37 – 39, banks acting as agent in SFTs and providing a guarantee to a customer.

We appreciate the Committee's proposed approach to the treatment of the exposure measure for banks acting as agent in SFTs when providing guarantees to customers. It is very commonplace for banks to provide these types of guarantees (more commonly referred to as indemnities) to their clients such as pension funds and other institutional investors. The indemnities are generally designed to protect the client for losses they may suffer in the event that a borrower defaults (such as where collateral held is insufficient to cover the value of the loaned securities). The use of a current exposure method is appropriate for agent securities lending transactions as the indemnities provided do not create leverage for the banks that provide them. We therefore fully support the approach outlined by the Committee that the exposure measure contribution for such indemnities be calculated on the basis of the counterparty credit risk. However we agree with the comments contained in the response to the consultation by the Committee on Securities Lending of the Risk Management Association (the "RMA") that further clarifications be made in respect of this part of the framework. We do not repeat the RMA's requests in detail in this letter but our members share the view that the current exposure treatment of banks acting as agents in SFTs should not be compromised as result of collateral being managed by the agent in accordance with normal market practice, or in circumstances where the scope of the indemnity may extend beyond the difference in value between loans and collateral (for example to cover other incidental costs such as transaction

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costs). The RMA's response more fully outlines the areas in which further clarifications would be helpful and we encourage the Committee to consider these.

In summary we believe that the proposed framework and treatment of SFTs will likely serve to cause banks to reduce activity in these important markets. This will have negative consequences for long term investors (who will be deprived of valuable revenues from securities lending) , the secondary markets for bonds and equities (in terms of both poorer liquidity and general market efficiency), and will precipitate increases in funding costs for governments and corporations.

Constraining SFTs will also impair the ability for market participants to mobilise collateral to meet the needs of the growing body of regulatory reforms which are demanding greater use of collateral within the financial system.

We hope that the Committee will consider these effects and review the basis on which SFTs are treated within the framework.

Yours sincerely,

Kevin McNulty
Chief Executive