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March 31, 2021

Ms. Carolyn Rogers
Secretary General
Basel Committee on Bank Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: BCBS Minimum Haircut Floors for Securities Financing Transactions

Secretary General Rogers:

The Securities Industry and Financial Markets Association (“**SIFMA**”)¹, the Association for Financial Markets in Europe (“**AFME**”)² and the Global Financial Market Association (“**GFMA**”)³ appreciate the opportunity to comment on the proposed Technical Amendment to the Minimum Haircut Floors for Securities Financing Transactions (“Minimum Haircut Framework”) published by the Basel Committee on Bank Supervision (“**BCBS**”) at the end of January 2021.

We are encouraged by the BCBS’s continued improvement to the SFT Haircut Floor Framework. The purpose of this letter is to respond to the request for comment regarding the issues raised in the Technical Amendment. Nonetheless, we also thought it appropriate to again raise concerns regarding the wider SFT haircut framework. We judiciously only included issues where we believe the approach is

¹ **SIFMA** is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry’s nearly 1 million employees, we advocate on legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

² **AFME** represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

³ **GFMA** represents the common interests of the world’s leading financial and capital market participants, to provide a collective voice on matters that support global capital markets. We advocate on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows, benefiting broader global economic growth.

materially inconsistent with the objectives and genesis of the framework designed by the Financial Stability Board (FSB) and Basel III goals of enhancing the robustness and risk sensitivity of the standardized approaches.

As noted in our previous comment letters, we endorse the policy intent of the Minimum Haircut Framework “to limit the buildup of excessive leverage outside of the banking system, and to help reduce the procyclicality of that leverage”.⁴ Indeed, minimizing regulated banks from providing unsustainable short-term financing to unregulated counterparties through insufficient collateral arrangement is appropriate. Nonetheless, we believe the framework in its current form requires critical enhancements to meet this policy goal, while avoiding disruption to the markets. This is especially true for the framework’s current treatment of securities borrowing transactions. Securities borrowing/lending is a demand driven activity, and its focus is not on providing funding, but rather it is driven by the demand for a particular security. The borrowers receive desired securities (not cash) and post cash or securities collateral to the lender and lenders (usually the holder of the securities such as pension funds, mutual funds), who receive collateral to cover the counterparty credit risk (and a fee) for lending the securities.

The securities lending market provides access to pools of securities that would otherwise be trapped in investment portfolios. Access to these pools of securities improves market liquidity, facilitates securities settlements, enhances price discovery, and reduces price volatility and bid offer spreads. Asset managers that are typical lenders in stock borrowing transactions receive fees for securities lend, improving the efficiency and returns of the portfolio, while risks arising from this activity are controlled and mitigated by the collateralization and operational processes that are often outsourced to agent lenders. For securities borrowers, these transactions provide access to securities needed to cover short sales or failed trades, hedge risks, satisfy the needs of their clients or satisfy margin and liquidity requirements.

Separately, we believe that a significant impact resulting from the minimum haircuts for SFTs is going unnoticed because it has not been consistently captured in the semi-annual Basel monitoring exercises, partly due to a lack of clarity in the rules and partially because banks themselves have not yet incorporated the minimum haircuts into their calculations. To understand the impact of the minimum haircuts on SFTs, according to a standardized interpretation of the rules, GFMA engaged with GARP and 14 global banks to run an impact assessment in 2018.⁵ The SFT haircuts framework would increase SFT RWAs by 61% under the advanced approach and by 63% under the standardized approach, with over half of that impact coming from securities borrowing. This would have detrimental impacts on the repo and securities lending markets:

⁴ <https://www.fsb.org/2015/11/fsb-publishes-reports-on-transforming-shadow-banking-into-resilient-market-based-finance/>

⁵ Full results available to authorities at a request, summary available in the 2018 GFMA and ICMA repo study: <https://www.gfma.org/wp-content/uploads/2019/05/gfma-icma-sft-study-december-2018.pdf>

- Securities lenders (mainly pension and mutual funds) may have to accept significantly lower returns for their portfolios due to lower demand
- Dealer banks may not be able to provide the same level of liquidity in case their ability to borrow securities to meet client demand is limited due to the haircut rules; and
- Short-sellers may need to seek for alternative ways to “short” securities and improve the price discovery process

Therefore, we provide comment on two essential amendments to better align the framework with its stated intent. These refinements include improving the differentiation of securities financing transactions from securities borrowing transactions where the intent of the transaction is to locate a specific security; and the partial recognition of collateral even when the transaction does not meet the minimum haircut floor instead of an unsecured loan treatment.

With regards to the updated formula as specified on page two in the consultation, specifically against the simple examples we had provided already in the GFMA's response to the FSB's consultation in 2016, we can confirm that the changes proposed do not improve the performance of the formula in any of the cases. We provide examples in Annex I where out-of-scope transactions result in the whole netting set that also include in-scope transactions to fail meeting the minimum haircut requirements. Such issues, which in our examples result in marginal failure to meet the haircut requirement at the portfolio level while the in-scope transactions individually meet the minimum haircut requirement, demonstrate why the penalty function should be revisited. In this context, we note that the FSB's original framework allowed for two options on how to implement the penalty function. Bearing in mind that the formula may in some cases result in ‘false negatives’ in terms of meeting the haircut requirement, we strongly recommend that the BCBS adopts the Option 2 instead of the Option 1 of FSB's suggestions for the penalty function⁶ in the BCBS framework.

Option 2 would avoid the cliff-effect and as a result ensures the most stable, predictable, and least arbitrary outcome while still providing a penalty for netting sets below a certain haircut level. As such, this is the industry's preferred approach for the design of the penalty function. As a less preferred approach, BCBS could provide banks an option to apply the capital penalty on a trade-by-trade basis to in-scope transactions that individually do not meet the minimum haircut requirement. As this approach is not always beneficial compared to a portfolio approach, this must remain an option as opposed to a requirement. This approach would at least ensure that a netting set of transactions would not receive a more punitive treatment than a scenario where each transaction would form its own netting set which would be less desirable from a credit risk perspective (please refer to Annex I for examples).

⁶ P. 14 – 16: https://www.fsb.org/wp-content/uploads/r_141013a.pdf?page_moved=1

Finally, we agree with the BCBS's revised text regarding CRE56.5 as it clarifies the party to which the restrictions to rehypothecate apply.⁷

Recommendations

- Exclude stock borrow transactions from the scope of the minimum haircuts on SFTs, as the purpose of these transactions is not to provide financing to counterparties, but rather to borrow a specific security in exchange for collateral. Borrows that the bank can demonstrate to be demand driven should be excluded from the minimum haircut requirements. Securities lending/borrowing is the only way to access otherwise trapped pools of in demand securities and unduly hampering the product and banks' ability to borrow securities may have significant unintended consequences to functioning of the broader markets
- The industry continues to believe that regulators should consider a more risk-sensitive approach by allowing partial recognition of collateral in relation to the size of the shortfall in assessing the RWA increase that results from not meeting the required minimum haircut. The netting set formula with its current scope results in failures to meet the minimum haircut floors at a netting set level, even if all in-scope transactions individually meet the requirements. We recommend updating the BCBS framework with the FSB's Option 2 for the penalty function as the best way to ensure consistency and stability of capital outcomes. At a minimum, BCBS should allow banks an option to apply the penalty on a trade-by-trade basis for in scope transactions that do not meet the minimum haircut requirement at a trade level.

1) Collateralized Securities Borrowing Transactions should be Excluded from the Minimum Haircut Framework

Introduction

In this section, we will discuss why it is inappropriate and inaccurate to treat all secured financing transactions (SFTs) similarly under the Minimum Haircut Framework. We strongly believe that securities borrowing transactions which are motivated by the need for a specific security should be excluded from

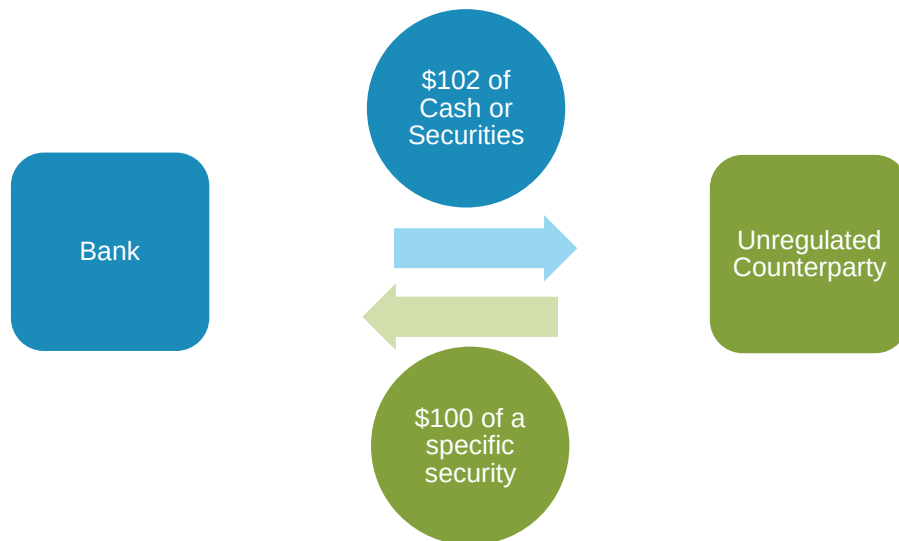
⁷ However, it remains unclear which scenario relates to a situation where the counterparty would borrow a security (the bank lent) and not use that security. By definition, the purpose for a non-bank entity to borrow a particular security is to be able to use it, e.g., cover a short position the entity has entered into. Therefore, such transactions where the bank was the lender of a security would never be exempted for the minimum haircut requirement given the condition associated with the exemption. This runs counter to the intent of exempting securities borrowing transactions from this minimum haircut requirement where the intent is to borrow a security rather than to provide financing.

the framework in conformance with the intent and purpose of the Minimum Haircut Framework as developed by the Financial Stability Board and the Basel Committee.

To illustrate how the motivation for a specific asset class influences the transaction type, we have provided an example of a security borrowing transaction and a reverse repo.

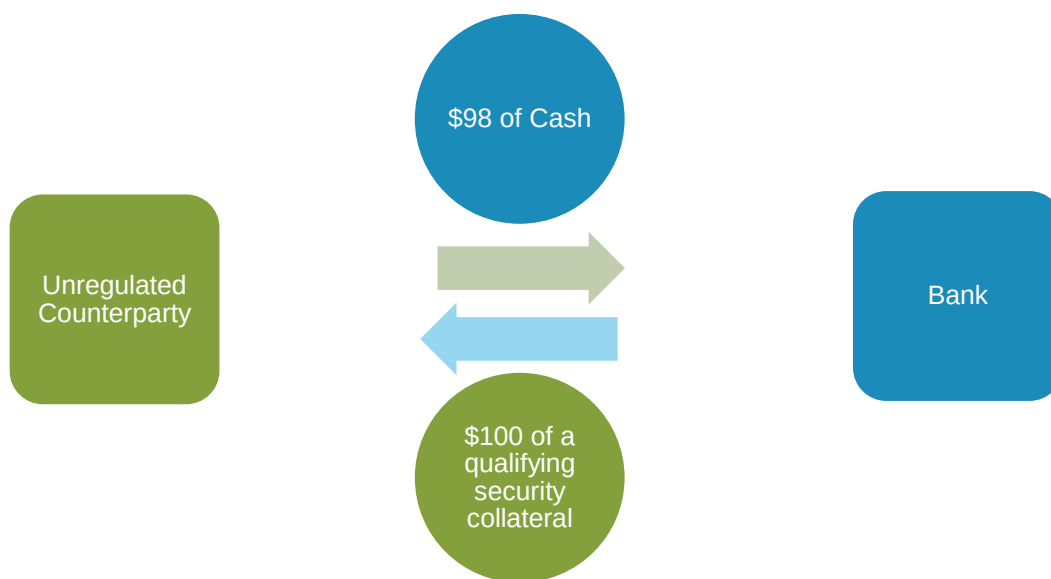
Collateralized Securities Borrowing

In the diagrams below, the bank initiates a transaction to receive a specific security. In return for the security, the bank provides cash to the counterparty. The cash amount is sized to both fully collateralize the transaction and pay a fee to the lender. The security and cash legs of the transaction are pictured below.



Reverse Repo

In the diagram below, a counterparty initiates a transaction to obtain cash either to fund the security or for other purposes. The counterparty sells a security to the bank with an agreement to repurchase that same security at a specified price at a specific time in the future. While the bank is provided a security in return for the cash, the bank is agnostic as to the specific security it receives. The bank's primary concern is that the security meets its collateral requirements.



The Minimum Haircut Framework was not intended to apply to Securities Borrowing Transactions.

Since its development at the Financial Stability Board (FSB), the Minimum Haircut Framework was intended to apply only to secured financing transactions (SFTs) where a bank extended credit to an unregulated counterparty. The FSB specifically developed the framework to address SFTs which involved leverage and where the transaction was procyclical. The framework was never intended to apply to SFTs that are securities borrowing transactions because these transactions are not financing transaction and are not inherently procyclical.

In 2015, the FSB stated that "securities borrowing can be excluded if the borrower of securities intends to use the received securities to meet a current or anticipated demand (e.g., delivery obligations, customer

demand, segregation requirements). Later in 2020⁸ and after the initial proposal by BCBS, the FSB slightly amended its language regarding the exclusion of securities borrowing transactions. It stated that “securities borrowing can be excluded from the scope of the qualitative standards for methodologies used by market participants to calculate haircuts if the borrower of the securities intends to use the received securities to meet a current or anticipated demand (e.g., delivery obligations, customer demand, segregation requirements).” Regardless of the refinements to the language between FSB proposals, the underlying characterization that a security borrowing transaction was not a financing transaction when it is intended to meet current or anticipated needs for a certain security has not changed. Consequently, securities borrowing should be excluded from the minimum haircut framework.

Basel III Revisions to the Minimum Haircut Framework Depart from the FSB Framework

As noted above, the FSB framework specifically made accommodations to remove securities borrowing transactions from the minimum haircut framework recognizing that borrowing transactions were not financing transactions. The Basel III revisions to the minimum haircut framework did provide a path to exclude collateralized securities borrowing through the insertion of some qualifying criteria. The criteria however are misplaced because they focus on the unregulated counterparties’ use of the collateral. Not only is this operationally cumbersome, it is difficult to reasonably confirm by the security borrower. Most importantly, it fails to ascertain whether the transaction is in fact motivated by the need for a specific security and thus suitability removed from the minimum haircut framework. Instead, we believe an appropriate criterion would focus on the motivation of the SFT.

Cash Collateralized Securities Borrowing Transactions should be Exempted Based on Motivation

We recommend that the proposal refocuses the qualifying criteria essential to exempt a collateralized security borrowing on the intention of the security borrower in the transaction. We propose that the BCBS clarify that the minimum haircut framework excludes those transactions where the bank / security borrower can demonstrate, regardless of the form of legal agreement, the need for a specific security such as to satisfy delivery obligations, customer demand or segregation requirements, at a minimum. This alteration would provide a cleaner and enforceable approach that is supportive of the Minimum Haircut Framework’s intent. Moreover, this clarification would ensure that any transaction which is not entered into for financing purposes is properly excluded from the framework and that access to specific securities through securities borrowing arrangements is not interrupted.

⁸ <https://www.fsb.org/2020/09/regulatory-framework-for-haircuts-on-non-centrally-cleared-securities-financing-transactions-5/>

2) Revisions to the netting formula

The industry appreciates the Committee's efforts to revise the formula and we agree with the proposed changes. However, we believe that there is more to do to ensure that the framework is proportionate and results in the right outcomes. The GFMA provided already in its response to the FSB's consultation in 2016 examples under which the formula provides erroneous outcomes. We can confirm that the changes proposed do not improve the performance of the formula in this regard. We provide examples in Annex I where out-of-scope transactions result in the whole netting set that also include in-scope transactions to fail meeting the minimum haircut requirements.

Such issues, which in our examples result in marginal failure to meet the haircut requirement at the portfolio level while the in-scope transactions individually meet the minimum haircut requirement demonstrate why there is a need to revisit the penalty function. In this context, we note that the FSB's original framework allowed for two options on how to implement the penalty function. Bearing in mind that the formula may in some cases result in 'false negatives' in terms of meeting the haircut requirement, we strongly recommend that the BCBS allows for some supervisory discretion and adopts the Option 2 instead of the Option 1 of FSB's suggestions for the penalty function⁹ in the BCBS framework. At a minimum, BCBS should allow for an option to apply the penalty on a trade-by-trade basis for in scope transactions that do not meet the minimum haircut requirement at a trade level.

Sincerely,



Coryann Stefansson
Managing Director
SIFMA



⁹ P. 14 – 16: https://www.fsb.org/wp-content/uploads/r_141013a.pdf?page_moved=1

Jouni Aaltonen
Managing Director
AFME

A handwritten signature in black ink, reading "Allison Parent". The signature is fluid and cursive, with the first name "Allison" and the last name "Parent" clearly distinguishable.

Allison Parent
Executive Director
GFMA

Annex I: Netting formula examples

SFT Haircut Floors: Netting Set Examples

$$\frac{\sum C_t - \sum E_s}{\sum E_s} \geq f_{\text{Portfolio}} \left(\frac{\sum C_t}{\sum C_t \times (1 + f_t)} \right) - 1$$

Portfolio Haircut:

$$\frac{\sum C_t - \sum E_s}{\sum E_s} \geq f_{\text{Portfolio}}$$

Portfolio Floor:

$$f_{\text{Portfolio}} = \left[\frac{\sum \left(\frac{E_s}{1 + f_s} \right)}{\sum E_s} \right] \left/ \left[\frac{\sum \left(\frac{C_t}{1 + f_t} \right)}{\sum C_t} \right] \right] - 1$$

Netting Set 1 - Low Haircuts					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Reverse Repo (in scope)	-98	100	-2%	6%	Fail
Repo (out of scope)	100	-103	3%	N/A	N/A
Net trades	Cash	Collateral A	Haircut	Floor (f)	
Net Trade	2	-3	50.0%	6.0%	Pass

Net lent (Es)	2
Net borrowed (Ct)	-3
fs (net lent floor)	0%
ft (net received floor)	6%
(Es/(1+fs))/Es	1
(Ct/(1+ft))/Ct	0.94
Divide then - 1	6.0%

Netting Set 1 demonstrates that low haircuts on both the in-scope and out-of-scope transactions can result in a large minimum haircut on a net basis that exceeds the floor, highlighting the illogical outcomes of the framework.

Netting Set 2 - Weighted Towards Repos					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Repo (out of scope)	-1000	1065	-6%	N/A	N/A
Reverse Repo (in scope)	100	-112	12%	6%	Pass
Net trades	Cash	Collateral A	Haircut	Floor	
Net Trade	-900	953	-5.6%	-5.7%	Pass

Net lent (Es)	953
Net borrowed (Ct)	-900
fs (net lent floor)	6%
ft (net received floor)	0%
(Es/(1+fs))/Es	0.94
(Ct/(1+ft))/Ct	1
Divide then - 1	-5.7%

Netting Set 2 shows that because the in-scope reverse repo is part of a netting set with a large out of scope repo, the amount of collateralization required to pass the haircut floor on the reverse repo (12%) is considerably higher than standard market practice.

Netting Set 3 - Weighted Towards Reverse Repos					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Reverse Repo (in scope)	1000	-1060	6%	6%	Pass
Repo (out of scope)	-100	107	-7%	N/A	N/A
Net trades	Cash	Collateral A	Haircut	Floor	
Net Trade	900	-953	5.9%	6.0%	Fail

Net lent (Es)	900
Net borrowed (Ct)	-953
fs (net lent floor)	0%
ft (net received floor)	6%
(Es/(1+fs))/Es	1
(Ct/(1+ft))/Ct	0.94
Divide then - 1	6.0%

Netting Set 3 demonstrates that despite the in-scope reverse repo exceeding the haircut floor in isolation, when combined with a significantly smaller out-of-scope repo transaction, the net effect results in a haircut below the floor.

Netting Set 4 - Error					
	Cash	Collateral A	Haircut	Floor	Pass/Fail
Repo (out of scope)	-100	104	-4%	6%	Pass
Reverse Repo (in scope)	100	-107	7%	N/A	N/A
Net trades	Cash	Collateral A	Haircut	Floor (f)	
Net Trade	0	-3	-100.00%	#DIV/0!	Error

Net lent (Es)	0
Net borrowed (Ct)	-3
fs (net lent floor)	0%
ft (net received floor)	6%
(Es/(1+fs))/Es	#DIV/0!
(Ct/(1+ft))/Ct	0.94
Divide then - 1	#DIV/0!

Netting set 4 highlights a mechanical problem in the netting formula when the bank provides and receives equal amounts of cash, creating a computational error on a net basis.