March 27, 2015

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

Re: Consultative Document: Revisions to the Standardized Approach for Credit Risk

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Consultative Document of the Basel Committee on Banking Supervision ("BCBS" or "Committee").

INTRODUCTION AND BACKGROUND

BCBS published the above-captioned consultative document "Revisions to the Standardized Approach for Credit Risk" ("Consultative Document" or "Document") in December 2014 to "substantially improve the standardized approach for credit risk."[2]

The Document builds on two previous releases. First, in September 2013, the BCBS and the Board of the International Organization of Securities Commission ("IOSCO") issued a joint document, *Margin Requirements for Non-centrally Cleared Derivatives*, which is "the final policy framework that establishes minimum standards for margin requirements for non-centrally cleared derivatives."[3] Second, in March 2014, BCBS issued a release, *The Standardized Approach for Measuring Counterparty Credit Risk Exposure*, which outlined the BCBS Standardized Approach for measuring exposure at default for counterparty credit risk.[4]

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.

2 Consultative Document, page 1.

3 BCBS, *Margin Requirements for Non-centrally Cleared Derivatives* (September 2013), page 1.

4 BCBS, *The Standardized Approach for Measuring Counterparty Credit Risk Exposures* (March 2014). Ziad Fares and Benoit Genest of Chappuis Halder & Cie note that "[Counterparty credit risk] is defined as the

The Consultative Document would incorporate six key changes to the standardized approach:[5]

- Bank exposures would no longer be risk-weighted by reference to the external credit rating of the bank or of its sovereign of incorporation, but they would instead be based on a look-up table where risk weights range from 30% to 300% on the basis of two risk drivers: a capital adequacy ratio and an asset quality ratio.

- Corporate exposures would no longer be risk-weighted by reference to the external credit rating of the corporate, but they would instead be based on a look-up table where risk weights range from 60% to 300% on the basis of two risk drivers: revenue and leverage. Further, risk sensitivity would be increased by introducing a specific treatment for specialized lending.

- The retail category would be enhanced by tightening the criteria to qualify for the 75% preferential risk weight, and by introducing a fallback subcategory for exposures that do not meet the criteria.

- Exposures secured by residential real estate would no longer receive an automatic 35% risk weight. Instead, risk weights would be determined according to a look-up table where risk weights range from 25% to 100% on the basis of two risk drivers: loan-to-value and debt-service coverage ratios.

- Exposures secured by commercial real estate are subject to further consideration. The two options under consideration are: (a) treating them as unsecured exposures to the counterparty, with a national discretion for a preferential risk weight under certain conditions; or (b) determining the risk weight according to a look-up table where risk weights range from 75% to 120% on the basis of the loan-to-value ratio.

- The credit risk mitigation framework would be further amended by recalibrating supervisory haircuts and updating corporate guarantor eligibility criteria.

<u>SUMMARY OF COMMENTS</u>

This comment letter focuses on the Committee's approach to the treatment of re-hypothecation (or re-pledging) in the context of collateralized transactions and credit risk

risk that a counterparty defaults before honoring its engagements. This definition is by far too close to the Credit Risk definition, suggesting that CCR is a form of Credit Risk." Ziad Fares, Benoit Genest *CVA Capital Charge Under Basel III Standardized Approach* (April 16, 2013), page 4.

5 *Consultative Document,* page 2.

mitigation techniques. It stresses that treatment of margin and collateral and their re-hypothecation can have a significant impact on ultimate credit risk.

Specifically, an explicit prohibition on re-hypothecation for the OTC derivatives and securities-financing transactions must be in place for any potential exemption from the risk-weight floors. If re-hypothecation of margin and collateral is permitted, then transactions should be subject to risk weight add-ons as part of the standardized approach for credit risk.

COMMENTS

A prohibition on re-hypothecation for OTC derivatives and securities-financing transactions must be in place for any potential exemption from the risk-weight floors. If re-hypothecation of margin and collateral is permitted, then transactions should be subject to risk weight add-ons as part of the standardized approach for credit risk.

The Consultative Document introduces new credit risk mitigation techniques for exposures risk-weighted under the standardized approach, including exposures in collateralized transactions.[6] The Document notes that capital relief can be granted to collateral even if it is pledged or transferred. The only constraint that the Consultative Document places on collateral re-hypothecation is that:

> the legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of the default, insolvency or bankruptcy (or one or more otherwise-defined credit events set out in the transaction documentation) of the counterparty (and, where applicable, of the custodian holding the collateral).[7]

The Consultative Document does not address, however, the impact of the permitted re-hypothecation on credit risk, the effectiveness of risk mitigation when re-hypothecation takes place, or measures to reduce the risk of collateral re-hypothecation. In light of the extensive work that has been done showing the impact of collateral re-hypothecation on counterparty risk, credit risk, and financial stability risk, such an omission is a critical weakness of the Consultative Document.

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6 In September 2000, BCBS released the document "Principles for the Management of Credit Risk." In this document, the Committee stated that "credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms." BCBS, *Principles for the Management of Credit Risk* (September 2000), page 1.

7 *Consultative Document*, page 44.

The Committee on the Global Financial System ("CGFS") conducted an analysis of asset encumbrance, financial reform, and the demand for collateral assets, which explains why re-hypothecation can present challenges in the context of risk management:

> Rehypothecation refers to the right of financial intermediaries to sell, pledge, invest or perform transactions with client assets they hold; and it allows prime brokers and other financial intermediaries to obtain funding using their client collateral. Collateral reuse, in turn, usually covers a broader context where securities delivered in one transaction are used to collateralise another transaction, including the ability to reuse collateral through a change in (temporary) ownership. Yet the terms rehypothecation and reuse of securities are often used interchangeably; they do not have distinct legal interpretations.[8]
>
> While certain types of rehypothecation can be beneficial to market functioning, if collateral collected to protect against the risk of counterparty default has been rehypothecated, then it may not be readily available in the event of a default. This, in turn, may increase system interconnectedness and procyclicality, and could amplify market stresses. Therefore, when collateral is rehypothecated, it is important to understand under what circumstances and the extent to which the rehypothecation has occurred; or in other words, how long the collateral chain is.[9]
>
> A particular aspect that has received considerable scrutiny in the policy debate on securities financing markets is the extent to which rehypothecation activities should be permitted. The recent crisis experience suggests that greater reliance on rehypothecation in financial intermediaries' balance sheets will increase interconnectedness and make them more vulnerable to financial shocks. Rehypothecation of client assets can also delay the recovery of assets or even impose losses on beneficial owners. In addition, it can prompt intermediaries to build up leverage in good times, contributing to increased procyclicality of the financial system.[10]

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8 Committee on the Global Financial System, *Asset encumbrance, financial reform and the demand for collateral assets* (May 2013) (Bank for International Settlements), page 17. Professor Cyril Monnet of the University of Bern offers another definition of a re-hypothecation: "How would you feel if even though you were making regular monthly payments, your mortgage bank sold your house? This may seem like an odd question, but this type of situation happens every day in financial markets: A borrower pledges a security as collateral to a lender, and the lender sells the security to a third party, a practice known as rehypothecation."

9 *Id.*

10 *Id*. at page 32.

Yuji Sakurai of Bank of Japan and Yoshihiko Uchida of the University of California, Los Angeles concisely summarize the dangers of re-hypothecation:

> Although rehypothecation benefits the end users through cost reduction of derivatives trades, it also creates additional counterparty credit risk since the end user may not receive the collateral back when the dealer suddenly defaults. Plus, rehypothecation itself increases the default risk of a dealer since it is essentially off-balance-sheet leverage.[11]

The Financial Stability Board has also recognized the risk to financial stability arising from re-hypothecation, as reflected in its November 2012 proposal to strengthen oversight and regulation of shadow banking by imposing limits on re-hypothecation of client assets:

> [A]uthorities should ensure that regulations governing re-hypothecation of client assets address the following principles: financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary; in jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.[12]

However, the Consultative Document would adopt an overly permissive approach. As noted above, it would only condition rehypothecation on ensuring certain bank liquidation rights. This treatment of collateral in OTC derivatives and securities-financing transactions creates a serious loophole and poses a material threat of regulatory arbitrage. The credit risk framework is intended to reduce the negative consequences that follow when a bank borrower or counterparty fails to meet its obligations in accordance with agreed terms. However, rather than reducing credit risk, the suggested approach to re-hypothecation would simply relocate credit risk from the direct transaction to the re-hypothecation chain. Allowing an exemption from capital relief under such a re-hypothecation model undermines the objective of the Consultative Document.

In order to remedy this omission, the BCBS must consider two options. The first is to prohibit re-hypothecation of any collateral if it is to be eligible for any credit risk mitigation. Alternatively, if a counterparty is permitted to re-hypothecate its collateral, such re-

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11 Yuki Sakurai, Yoshihiko Uchida *Rehypothecation Dilemma: Impact of Collateral Rehypothecation on Derivative Prices Under Bilateral Counterparty Credit Risk* (19 August 2013), page 19.

12 Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking, Consultative Document* (18 November 2012), page 12.

hypothecated collateral should be subject to the credit risk weighting of the party receiving the re-hypothecated collateral, with the resulting capital treatment requirements to be applied on the side of the party that re-hypothecates it. Such treatment would either eliminate the credit risk of re-hypothecation or capture the credit risk of re-hypothecation via assessment of credit risk weighting on re-hypothecated assets.

CONCLUSION

The comment letter stresses that the treatment of margin and collateral and their re-hypothecation have a significant impact on credit risk. Consequently, an explicit prohibition on re-hypothecation for the OTC derivatives and securities-financing transactions must be in place for any potential exemption from the risk-weight floors. If re-hypothecation of margin and collateral is permitted, transactions should be subject to risk weight add-ons as part of the standardized approach for credit risk.

We hope these comments are helpful as the Committee continues work to ensure strong and resilient financial markets.

Sincerely,

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