FÉDÉRATION BANCAIRE FRANÇAISE

January 4, 2016

BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)'S CONSULTATIVE DOCUMENT ON HAIRCUT FLOORS FOR NON-CENTRALLY CLEARED SECURITIES FINANCING TRANSACTIONS

Question 1: Are there any weakness or further improvements to the proposals that the Committee should consider?

We wish to highlight the following remarks and comments on the BCBS' consultation:

1. **We recommend the authorities to set a level playing field between banks and non-banks on the contemplated Regulation on numerical haircut floors for securities financing transactions (SFTs)**

As already mentioned in our response to the FSB's consultation (dated 12 December 2014), **we support the extension of the numerical haircut floors framework on non-centrally cleared SFTs to non-banks-to-non-bank transactions**:

- We acknowledge that for the time being, the volume of non-bank-to-non-bank transactions could appear small enough so as to not represent a material threat to the financial stability. Nevertheless, expanding the framework is necessary to avoid an otherwise partial shift of activities from transactions involving prudentially regulated entities to transactions involving only unregulated ones. Such a shift would have a detrimental effect on the whole market encouraging the *shadow banking* development and leaving a high number of transactions not covered by appropriate rules and Regulations;

- From a competitive viewpoint, the extension of the rules to non-bank lenders would maintain a level-playing field between banks and non-banks lenders. Banks would be at a competitive disadvantage otherwise.

As a consequence, and in order to extend the contemplated Regulation to SFTs entered into by and between *shadow banking* entities, we wish to highlight the following points:

(a) **We would favor a market-based approach**

We understand that the BCBS prudential **approach** is not applicable to most entities of the *shadow banking* sector. However, it is legitimate to ask for a level playing field between banks and *shadow banking* entities performing the same SFTs business with identical risks.

Therefore, we encourage regulators to leave the prudential approach out and put in place a global market-based regulatory approach applying an identical framework of numerical haircut floors to both banks and non-banks.

<u>In this context, we welcome the FSB publication dated 12 November 2015 recommending the application of numerical haircut floors notably to cover non-bank-to-non-bank transactions.</u>

(b) <u>**This market-based approach should be applicable in the same timeline, on a consistent basis and in all jurisdictions**</u>

- We consider that the market will adjust all the more easily to this new Regulation by being global. In particular, the extension of the numerical haircut floors framework to *shadow banking* entities should take place **at the same time as its application to** transactions involving banks;
- We also consider that the content of the proposed rules such as **the haircut floors levels should be strictly similar and calculated identically** for any SFTs, whether they are entered into between banks and non-*bank*s or between non-*bank*s;
- The SFTs markets in the EU and in the US operating differently, even a common Regulation may have different effects in these two markets. Therefore, there is a **need for international coordination** so that jurisdictions move at the same time and in the same direction to prevent regulatory arbitrage.

Again, this request is consistent with the **FSB's approach highlighted in its "*Regulatory framework for non-centrally cleared SFTs*"** (published on November 12, 2015). In this document, the FSB states that "*to ensure shadow banking activities are fully covered, to reduce the risk of regulatory arbitrage, and to maintain a level playing field, the FSB believes that it is essential to extend the scope of application of the numerical haircut floors to also cover non-bank-to-non-bank transactions*."

2. We consider that the treatment as "*unsecured loans*" of SFTs which do not meet the haircut floors is strongly questionable and even unjustified

In its consultation, the BCBS considers that "*in-scope SFTs which do not meet the haircut floors must be treated as unsecured loans to the counterparties*" (ref. draft paragraph 143 (vii)). This analysis is linked to the BCBS's purpose to incentivize banks to set their collateral haircuts above the floors: indeed, banks not complying with this request would be required to higher capital requirements.

In order to address this unintended consequence, we propose to reword the point 143(vii) in the text of the proposed rules as following:" *In-scope SFTs which do not meet the haircut floors must be treated as unsecured loans to the counterparties*<u>***, when calculating the capital requirements***</u>".

3. **We agree with BCBS's proposal to exclude from the scope of the Regulation SFTs which "*primary motive is to borrow securities rather than to lend cash*"**

In its consultation, BCBS considers that "*SFTs where the primary motive is to borrow securities rather than to lend cash*" should be excluded from the scope of the regulation (ref. (v) of point 2 of the consultation).

We agree with this position and would like that the BCBS makes it even clearer in its final publication.

4. **We ask for clarifications on a number of notions used in the BCBS's consultation**

a) "*Portfolio*"

We wish the BCBS to clarify the notion of "*portfolio*" used in its consultation (ref. notably the (c) of point 3 of the consultation).

Our purpose is to obtain confirmation that **this notion covers only the "*prime brokerage*" activities**, the latter activities being dedicated to institutional investors such as hedge funds and comprising the provisions of various services, including SFTs.

b) "*Netting set*"

We wish the BCBS to clarify the notion of "*netting set*" used in its consultation (ref. notably the (a), (b) and (c) of point 5 of the consultation).

Our purpose is to confirm that **this notion covers only the repo and securities lending master agreements** executed by the banks and their counterparties (such as GMRAs and GMSLAs) and that the envisaged rules **will not adversely impact the framework of repo and securities lending transactions** entered into by the banking sector.

c) "*Government securities*"

When defining the scope of application, the BCBS refers to "*government securities*" (cf. (iii) in point 2 of the consultation). We **seek confirmation that this category covers all issuance by any public and quasi-public entities benefiting from a favorable treatment under the standard framework for credit risk,** including (but not limited to) agencies, public sector entities or multilateral development banks.

d) Further clarification on the scope of application

Considering the BCBS's goal to target *shadow banking* activity, we suggest **to explicitly exclude all transactions entered into by and between regulated entities belonging to the same group** so as to avoid the situation where banks would be submitted to any haircut requirements when they deal on an intra-group / inter-affiliate basis.

Question 2: Are there any specific implementation challenges with the proposals?

From a general viewpoint, we consider that **the BCBS's proposed rules may raise operational constraints alongside their implementation by the banks**.

1. **The exemption for SFTs where the primary motive is to borrow securities rather than lend cash raises some implementation concerns**

Whereas we fully support the FSB's proposal that numerical haircut floors are not relevant when the purpose of the transaction is to borrow / lend a specific stock, we consider that **it does not make sense to restrict / limit this exemption only to cases where the lender of the securities reinvests the cash collateral into a separate reinvestment fund and/or account subject to regulation**. Indeed, (i) it will be almost impossible for the bank to know what the entity that has received the cash collateral will do with it and then almost impossible for the bank to benefit from this exemption, and (ii) non- bank counterparties will never accept to sign contracts including such representations.

What we propose is to look at the collateral direction:

(i) If in a securities borrowed transaction, the bank is subject to haircut requirements (i.e. the bank posts cash collateral in excess of the value of the securities received) vis-a-vis the *shadow banking* entity, we can consider that this transaction is not a financing transaction of *shadow banking* but just a borrow/lend transaction;

(ii) If the bank has received haircuts (i.e. the bank receives more securities than the cash it has lent) from the *shadow banking* entity, we can consider this transaction as a transaction financing the *shadow banking* industry.

2. **The BCBS proposal aiming at incentivising through higher capital requirements raises some technical implementation concerns**

The BCBS intention is to "incentivise banks to adopt the floors, but still allow them to hold additional capital if they do not" [d340 Section 3 paragraph (b)]. The solution to implement this key principle is to impose higher capital requirements if collateralisation is considered as insufficient. If the principal is to be implemented through capital requirements add-on, which is not our favoured solution, we believe that **the proposal bears a couple of shortfalls**.

(1) The proposal exhibits a strong cliff effect when the amount of collateral passes the haircut floor threshold.

(2) If collateralisation is seen insufficient, there is no incentive to hold collateral: any amount of collateral below the haircut floor leads to the same amount of counterparty credit risk (CCR) exposure at default (EAD).

This is made clear in the example below. While currently the counterparty credit risk EAD (here using the Financial Collateral Comprehensive Method (FCCM) is a linear function of the amount of collateral, the Basel Committee proposal would result in a sharp increase of EAD at the threshold (in the example equal to 101.5 M€ - the haircut floor being equal to 1.5%). Holding even less collateral does not result in any increased EAD. Hence, the proposal may result in requiring even less collateral from in-scope counterparties as it does not make any difference in term of risk weighted assets.

We propose an alternative whereby the amount of additional collateral is proportional to the amount of collateral shortfall.

- If the collateral amount is above the haircut floor

  Usual CCR exposure calculation, both under the Basel Committee and the alternative proposal:

$$EAD^{(FCCM)} = \text{Max}\{0;\ E \cdot (1 + H_E) - C \cdot (1 - H_C)\}$$

- If the collateral amount is under the market floor in the Basel Committee proposal

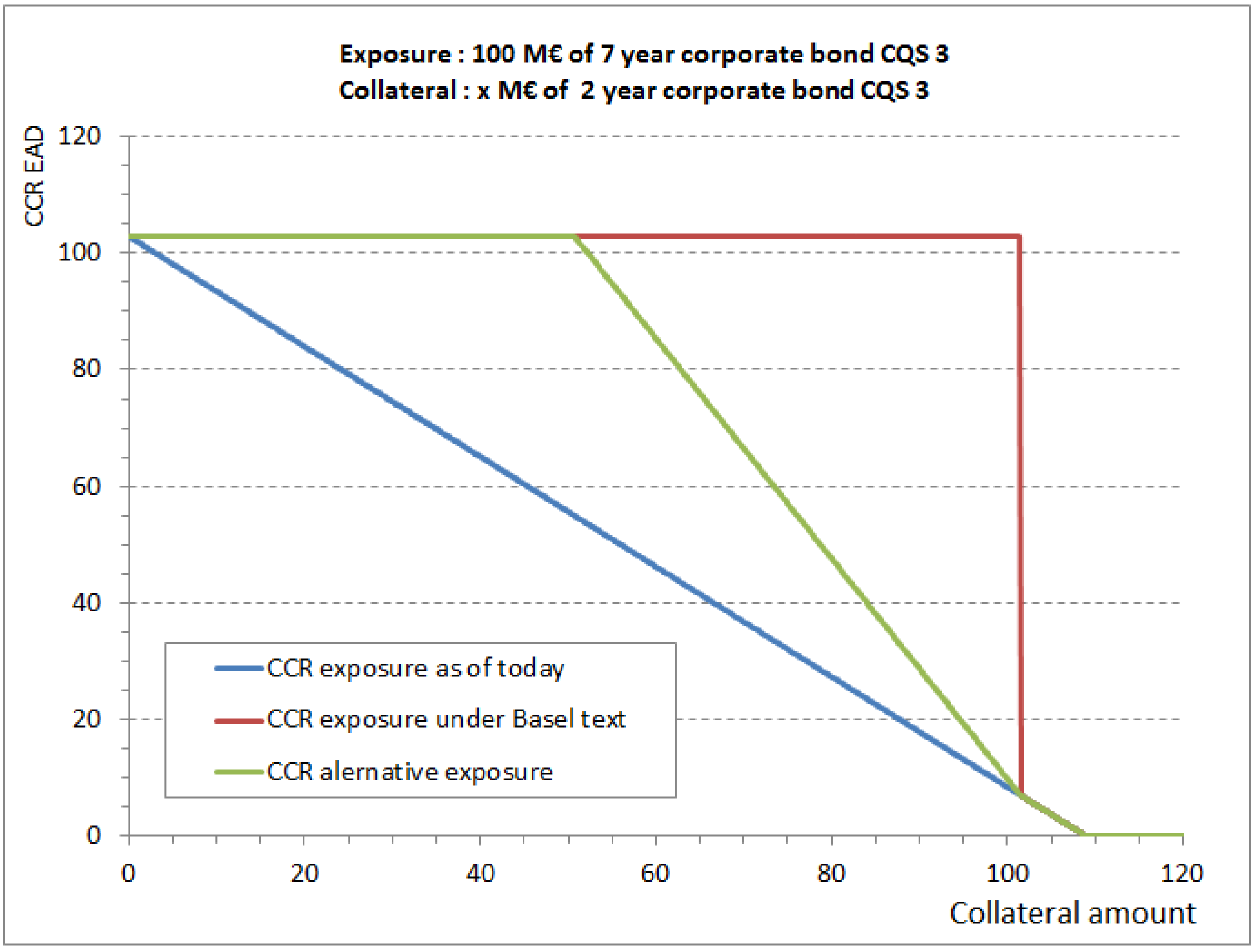
  The collateral value is set to zero with a resulting uncollateralised exposure

$$EAD^{(FCCM)}_{Basel} = E \cdot (1 + H_E)$$

- If the collateral amount is under the market floor in the alternative approach

  The collateral amount is reduced by the amount of shortfall of collateral, E·(1+f)-C

$$EAD^{(FCCM)}_{Alternative} = \text{Max}\left\{0;\ E \cdot (1 + H_E) - \underbrace{\text{Max}\{0; C - (E \cdot (1 + f) - C)\}}_{\text{Collateral amount adjusted by the amount of collateral shortfall}} \cdot (1 - H_C)\right\}$$



3. **The inconsistency between the netting-set and portfolio approached also raises technical implementation concerns**

The Basel Committee is introducing a specific method when collateralization is done at portfolio level. We welcome this level of flexibility in the proposed framework which is able to cope with portfolio level collateralisation.

However, we believe that **the outcome of the framework should be similar whichever the approach. This is unfortunately not the case**. The two examples below show that identical portfolios could lead, under the portfolio level approach to either a higher or lower net exposure amount. This is due to the “by collateral” treatment under the netting-set approach [Section 5(c)] and in part due to the out-of-scope transactions that enters the calculations but not the higher capital requirements process.

	Portfolio	Instrument	Cash 0%	Asset A 10%	Asset B 10%	Actual haircut	Haircut floor	Status	Comment
Section 5(c) netting set approach	Actual	Trade A	1,000	-1,102		10.200%	10.000%	Compliant	
		Trade B	1,000		-1,099	9.900%	10.000%	In breach	
	Adjusted	Trade A	1,000	-1,102					No change
		Trade B	1,000		0				Trade set un-collateralised
Section 5(d) portfolio approach	Actual					10.050%	10.000%	Compliant	
	Adjusted	0	1,000	-1,102					No change
		0	1,000		-1,099				No change

	Portfolio	Instrument	Cash 0%	Asset A 10%	Asset B 10%	Actual haircut	Haircut floor	Status	Comment
Section 5(c) netting set approach	Actual	Trade A	1,000	-1,101		10.100%	10.000%	Compliant	
		Trade B	-1,000		1,102	-9.256%	-9.091%	In breach	
	Adjusted	Trade A	1,000	-1,101					No change
		Trade B	-1,000		1,102				Out-of-scope
Section 5(d) portfolio approach	Actual					-0.048%	-0.002%	In breach	
	Adjusted	0	1,000	0					Trade set un-collateralised
		0	-1,000		1,102				Out-of-scope

If the portfolio-level approach was applied in all circumstances and the applicable higher capital requirement is made proportional to the shortfall of collateral as seen in the previous section, then we believe that the issue would solved. We therefore recommend such an implementation if the Basel Committee was to retain a regulatory treatment of under-collateralisation of the shadow banking sector.