The International Securities Lending Association
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January 5th 2016

The International Securities Lending Association (ISLA) response to the Basel Committee on Banking Supervision's consultative document, Haircut floors for non-centrally cleared securities finance transactions

Dear Sir,

On behalf of our members, ISLA would like to thank you for the opportunity to comment on the above consultation paper.

Our members consider the level of minimum haircuts as appropriate and are commensurate with current levels of haircut provided in the markets today. However, in order to monitor and ensure compliance, our members seek further clarification on certain points which we have detailed under our response to question 1 below.

Q1. Are there any weaknesses or further improvements to the proposals that the Committee should consider?

1. Definitions

In order to ensure a consistent and accurate application our members request the following terms are clearly defined in the final text:

I. Table of minimum haircuts

In the table of minimum haircuts, reference is made to *Main index Equities*. It would be helpful if this term is clearly defined and further guidance provided for the approach for convertible bonds, which under Basel III RWA calculations are classified in the same category as their underlying equity.

II. Scope

Paragraph 2 describes the scope of application and refers to financing provided to non-banks. In the proposed rules text, paragraph 143 (i) defines this as "*counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international norms".* Please confirm that this means institutions such as Insurance companies and pension funds, which are subject to prudential requirements, are therefore out of scope.

Paragraph 2iii exempts transactions backed by government securities and we would like confirmation that this description includes securities issued or guaranteed by government sponsored entities.

Also, consideration should be given to the treatment of supranational issues, which typically have lower haircut requirements than corporate bonds and may, in some instances currently fall below the minimum haircut levels required.

In paragraph 2v an exemption is given where cash collateral is invested in *"a reinvestment fund or account subject to regulations or regulatory guidance meeting the minimum standards for reinvestment of cash collateral by securities lenders set out in Section 3.1 of the August 2013 Report.".*

It should be noted that, in some cases, cash collateral is re-invested in a money market fund available to other investors who may be investing cash from other sources and for other purposes that do not require the application of these minimum standards. Economies of scale mean that this is often the most efficient approach for the investors. This means that meeting the requirements of the exemption may lead to increased costs.

In some cases the lender or their agent constructs a specific cash reinvestment account or fund that meets the minimum standards detailed, but that is not subject to regulation or regulatory guidance. This may be because, for instance, the underlying lender does not have authority to invest in such a fund (eg has restriction on investing in pooled funds). Nevertheless the cash collateral is reinvested conservatively and in accordance with the minimum standards described. We believe it would be unreasonable to penalise such a lender and believe that exemption should be provided where the lender provides representation that cash collateral reinvestment meets the minimum standards described in Appendix 1.

2. **Capital treatment**

Whilst it is recognised that the impact of falling below minimum haircut levels needs to be sufficiently penal to encourage compliance, we strongly believe that treating the transaction and particularly the entire netting set as fully unsecured is particularly punitive and that some recognition of the collateral held should be given.

The original FSB recommendations referred to two options in respect of the capital treatment of SFTs falling below the minimum haircut levels and the BCBS paper proposes to adopt the first option of treating the whole exposure as unsecured, which the FSB noted would be "substantially the most punitive" However we believe that the FSB's option 2, which reduces the value of collateral in proportion to the haircut shortfall, meets the objectives of ensuring compliance and is more consistent with the BCBS's risk-based capital framework, and should be given more consideration.

Also, the proposal is silent in respect of when the adjustment in capital should be applied and consideration needs to be given to the potential situation where a bank falls below the minimum haircut levels for a short period of time due to settlement failures and other operational issues which may be outside of their control. The adjustment in capital calculation needs to be applied after a period of time where shortfalls caused by operational issues can be corrected.

3. Disclosures (D1 and D2)

ISLA supports improved disclosure and transparency of SFTs and is currently working closely with ESMA to develop the Securities Finance Transaction Regulation which includes significant regulatory reporting requirements. We believe that the reporting required under SFTR will enable regulators to monitor compliance of the minimum haircut floors without the need to develop further regulatory reporting and strongly urge regulators to utilise this information rather than ask the market to develop specific reporting for this purpose.

The onus of disclosure is on the agent lender, who may be undertaking cash re-investment on behalf of the underlying investor or beneficial owner. The level of disclosure has been greatly improved over recent years at both the request of beneficial owners and by various new regulations (such as UCITS guidelines and Solvency II). However it is unclear how this will be enforceable under this requirement, where the agent lender is not a bank and so not directly subject to the requirements

Q2. Are there any specific implementation challenges with the proposals?

In order to implement the rules accurately and efficiently, banks will need to discuss and seek representation from each of their lenders, and in turn agent lenders will need to seek these from their underlying beneficial owners, and implementation timeframes should reflect this undertaking.

Notwithstanding that the number of beneficial owners involved in securities lending mean that seeking representations is a significant task, the proposals seem to assume that representations will be readily available for securities lending activity where the primary purpose is not financing. However our members have voiced significant concern that the exemptions may not be easily obtained, as beneficial owners may co-mingle cash as a matter of course, and so may not be prepared to provide the representations as required, even where cash collateral is invested within the parameters stated.

Without the representation, beneficial owners, who currently receive at least 100% of loan value in cash collateral, will only receive 94% against equity loans which will significantly change the risk profile of lending and be unacceptable for most beneficial owners. As beneficial owners generally view securities lending as an additional activity providing incremental revenue, not as a core requirement, this may lead to beneficial owners changing their approach to the activity including some withdrawing completely. This has two potential impacts; to significantly reduce liquidity in these markets and/or, to drive beneficial owners to accept more non-cash collateralisation, and thus seemingly suggesting that cash, the most liquid form of collateral, is in some way less acceptable.

It should also be noted that in order to meet the requirements of Article 15 of the SFTR, Clifford Chance have been engaged jointly by ISLA/AFME/ISDA/ICMA to draft a statement pertaining to certain representations from lender to borrower. This statement will be available for adoption in Q1 2016 so the substantial task of obtaining representations across the market may have already been undertaken, so any further requirements will require a duplication of this effort.

Yours sincerely,

Kevin McNulty

Chief Executive

The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. It has approximately 100 full and associate members comprising insurance companies, pension funds, asset managers, banks, securities dealers and service providers representing more than 4,000 clients. While based in London, ISLA represents members from more than sixteen countries in Europe, and the rest of the world.. For more information please visit the ISLA website