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# COMMITTEE ON SECURITIES LENDING

March 11, 2016

The Committee on Securities Lending of the Risk Management Association (the “RMA”)<sup>1</sup> welcomes the opportunity to submit this letter to the Basel Committee on Banking Supervision (the “Committee”) with respect to the Revisions to the Standardized Approach for credit risk – second consultative document (“Standardized Approach”). We thank the Committee for their diligence in developing a simple yet suitable approach which appropriately measures and capitalizes the risks for Securities Financing Transactions (“SFTs”). The proposed Standardized Approach has addressed most of the concerns previously raised by the industry, maintaining a conservative estimate of Exposure at Default (“EAD”) while encouraging market participants to undertake positive risk management actions.

The EAD and associated risk weighted asset measure under the Standardized Approach has multiple applications beyond its use within Risk Based Capital (“RBC”) calculations, including as a floor for Advanced Approach banks in the U.S regulatory stress testing such as under the Comprehensive Capital Analysis and Review (“CCAR”) process in the U.S., and potentially the Basel Large Exposure Regime and U.S. Single Counterparty Credit Limits. Additionally, in the United States it may be used for bank affiliate transaction limits under Sections 23A and 23B of the Federal Reserve Act and Regulation W. Due to its multiple regulatory uses it is critical that the EAD measure under the Standardized Approach is conservative and simple to understand yet risk sensitive.

In Section I of this letter, we discuss SFT’s generally, including how they are structured and the role they play in the financial markets. In Section II, we explain additional adjustments that we propose to the Standardized Approach with regards to the calibration of the SFT formula. In Section III, discusses concerns related to the counterparty risk weighting of corporate counterparties in jurisdictions that are unable to rely on external credit ratings.

## **I. Background on Nature of Securities Lending Transactions**

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The RMA Committee on Securities Lending acts as a liaison for RMA member institutions involved in agent lending functions within the securities lending industry, by providing products and services including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

SFT's play a critical role in the efficient functioning of financial markets, supporting market liquidity and facilitating more efficient pricing, lowering investor transaction costs. SFT's also aid in the timely settlement of securities transactions and in market-making and hedging activities. In addition, securities lending provides important benefits to the primary owners of the lent securities, which include pension funds, government funds and collective investment schemes, by enabling the generation of low-risk, incremental returns on their investment portfolios. These returns are used to enhance investment performance and to offset administrative and other portfolio costs. Such benefits cannot flow to market participants if the broker-dealers and other intermediaries involved in securities lending and borrowing transactions are unnecessarily constrained.

The benefits of securities lending transactions are well-known not only to the market, but also to the supervisory community. Time and again global regulators have described the benefits of securities lending. For example, the International Organization of Securities Commissions and the Committee on Payment and Settlement Systems have stated that securities lending markets are a "vital component of domestic and international financial markets, providing liquidity and greater flexibility to securities, cash and derivatives markets."<sup>2</sup> The Federal Reserve Bank of New York (the "FRBNY") has determined that securities lending transactions play a key role in both fixed income and equity markets.<sup>3</sup> Moreover, the FRBNY noted that securities lending enhances price discovery, market efficiency and liquidity.<sup>4</sup> At year-end 2015, a total of approximately \$1.1 trillion in securities were on loan; about \$565 billion of these securities were equity securities.<sup>5</sup>

Traditional SFT's are driven by the demand of an end user to gain access to a particular security. The end user typically borrows the security from a broker-dealer intermediary, who then accesses the in-demand security from an underlying beneficial owner via an agency securities lending provider, which is typically a large custodial bank. The collateral pledged against the borrowed security is often cash, which is invested in short-term money market instruments, such as 2A-7 money market funds in the U.S. or UCITS money market funds in Europe. The purpose of such transactions is not to provide financing to the securities lender (i.e. the underlying beneficial owner) and certainly not to finance the securities borrower, but rather to gain access to the demanded security for the end user while providing the beneficial owner with low-risk, incremental returns on its investment assets.

## **II. Proposed Adjustment to the Standardized Approach**

We appreciate the improvement in the proposed Standardized Approach and believe that it more appropriately measures the true risk of these transactions compared to the materially flawed haircut-based Comprehensive Approach. By adjusting the formula for SFTs to address both systemic and

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<sup>2</sup> IOSCO & CPSS, *Securities Lending Transactions: Market Development and Implications* (July 1999), at 2, available at <http://www.bis.org/cpmi/publ/d32.htm>.

<sup>3</sup> See, e.g., FRBNY, *Staff Report: Repos and Securities Lending* (Dec. 2011, revised Feb. 2013), at 1, 17, available at [http://www.newyorkfed.org/research/staff\\_reports/sr529.pdf](http://www.newyorkfed.org/research/staff_reports/sr529.pdf).

<sup>4</sup> *Id.* at 17.

<sup>5</sup> RMA Securities Lending Composite Survey data, 4<sup>th</sup> quarter 2015.

idiosyncratic risk, the Committee has recognized the value of correlation and diversification within a portfolio of SFTs and the associated collateral received. Such adjustments will create the appropriate incentives for market participants to manage SFT portfolios in such a manner as to minimize potential risk on a portfolio level basis.

Based on the revised proposal the EAD for SFT portfolios remains many multiples higher than would result under a simple value-at-risk methodology, as permitted under the Advanced Approach.<sup>6</sup>

While the proposed Standardized Approach is a significant improvement over the existing methodology, we would propose one adjustment to the formula as it pertains to the calculation of “N,” the number of securities to be included in the denominator of second component of the formula. The currently proposed formula excludes securities that are less than 10% of the value of the largest securities within the netting set. We are generally supportive of excluding small loan or collateral positions from the diversification calculation; however basing the criteria on the largest security may skew the results in some instances. Both fixed income and equity securities are typically lent to the same borrower. Generally, equity on-loan portfolio will be comprised of a large number of securities; whereas fixed income on-loan portfolios may reflect a smaller number of positions. For example portfolios with large positions in fixed income such as sovereign debt, it is possible that 10% of a single loan may be more than the value of all other loans and pieces of collateral. We think that this issue can be easily addressed by changing to formula for securities to be included in “N” by making the criteria based on a percentage of the average size of loan and collateral securities. Otherwise, it may be more advantageous within the EAD calculations to have separate/smaller netting sets, while in practice the broader netting set could lead to greater risk reduction opportunities.

Consider for example, a netting set made up of two loans; \$100M US Treasury and 20 equity securities issuances worth \$5M each. This is collateralized, in turn, by 40 equity securities issuances worth \$5M each, for a total of 61 positions with an aggregate value \$400M (for the sake of simplicity, we are ignoring the excess collateral that would back the two securities loans). Using the methodology proposed by the Basel Committee, any equity securities issuance worth less than \$10M would be excluded from the netting set, which would result in the exclusion of all but the US Treasury from the netting set. In order to correct this limitation, we suggest that minimum size be defined not on the basis of the largest securities issuance, but instead on the basis of the average size of all securities issuances within the netting set. Using our above example and assuming calibration of the methodology at 20% of the average size of all securities issuances in the netting set, this would mean that an equity securities issuance would only be excluded if they were worth less than \$1.31M, a far more proportional standard that is nonetheless consistent with the intent of the underlying methodology.

### **III. Corporate Exposure Risk Weightings for Jurisdictions Precluding the use of External Credit Ratings**

We appreciate the fact that the Task Force has recognized the potential differences in Risk Weighted Assets (RWA) arising from restriction on the use of credit ratings in certain jurisdictions and believe the development of an alternative framework for corporate exposures utilizing the “investment grade” approach is well warranted. The “investment grade” distinction increases risk sensitivity and promotes prudent counterparty management practices in this jurisdictions that do not permit the use

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<sup>6</sup> The revised approach for SFT produces RWAs which are approximately 14x to 16x greater in some cases than simple VaR methodologies.

of credit ratings to assess risk weighting. However, we believe that the risk weighting of 75% for investment grade corporate exposures remains too conservative and will continue to drive differences in RWA across banking organizations based solely on the organization's ability to use external credit ratings

By flooring the investment grade corporate exposure risk weighting at 75% the risk associated with the highest credit quality corporate exposures remains significantly higher than the risk weightings for the highest credit quality corporates under the ratings based approach. Corporate exposure rated AAA/AA to A- attract 20 and 50% risk weightings respectively. The significant discrepancy between approaches may lead to perverse incentives and unintended consequences that may increase overall global systemic risk.

#### **IV. Conclusion**

In conclusion we would like to thank the Task Force for finding a practical solution to recognize the benefits of correlation and diversification within the proposed Comprehensive formula SFTs. It is our view that the newly proposed formula maintains the simplicity required for a standardized approach while better reflecting the economic realities of a portfolio of SFTs; thereby creating a more risk sensitive approach and reducing the likelihood of regulatory arbitrage from participants utilizing other economically similar transaction types. Despite the increased risk sensitivity, the proposed formula continues to result in very conservative EADs relative to Internal Model Methods or Simple VaR calculations. As previously noted, while we encourage the adoption of the proposed method for SFTs we think an adjustment to the calculation of "N" based on a percentage of the mean value of securities in a netting set rather than on a percentage of the highest value security would be prudent. Additionally, while we are pleased to see that the Task Force has recognized that a separate method of calculating counterparty risk weights for corporate exposures is necessary the proposed methodology would result in significantly different risk weights for certain counterparties across jurisdictions. We would encourage the Task Force to examine more granular methods for jurisdictions that are not permitted to utilize external ratings and/or lower the proposed weighting for investment grade exposures.

Sincerely,



Director  
Securities Lending & Market Risk  
Risk Management Association



Chairman  
Committee on Securities Lending  
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