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March 27, 2015

Via Electronic Submission

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

Re: Revisions to the Standardised Approach for Credit Risk

Dear Sir or Madam:

The Committee on Securities Lending (the “RMA Committee”) of the Risk Management Association (the “RMA”) ¹ appreciates the opportunity to submit this letter to the Basel Committee on Banking Supervision (the “Basel Committee”) on its behalf and on behalf of numerous of its members, including The Bank of New York Mellon, Deutsche Bank, Goldman Sachs, JP Morgan Chase, State Street Corporation, The Northern Trust Company and other financial institutions that participate in the securities lending industry as securities lending agents (“Agent Banks”) on behalf of their clients. ² This letter addresses the Basel Committee’s consultative document (the “Consultative Document”) on revisions to the Standardised Approach for credit risk. ³

¹ The RMA Committee acts as a liaison for RMA member institutions involved in agency 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.

² The same issues and approaches used to resolve the issues described herein with respect to agency securities lending also apply to another important activity of agency banks, agency repo transactions. Thus, while for convenience this letter focuses on agency securities lending, the RMA hereto respectfully submits that the Basel Committee also consider these comments to apply equally to agency repo transactions.

³ Basel Committee, *Revisions to the Standardised Approach for credit risk* (Dec. 2014), available at <http://www.bis.org/bcbs/publ/d307.pdf>.

Executive Summary

- Agency securities lending is a well-established, safe and sound activity that supports global capital markets activities. Agent Banks typically (because of legal requirements, client risk avoidance, and/or a desire by clients to have agent banks “validate” their programs by providing such protection) provide a securities replacement guarantee, more commonly known as borrower default indemnification, to securities lending clients, which creates the exposure (with respect to the borrower) under the Basel III capital framework.
- The Comprehensive Approach substantially overstates the credit risk associated with indemnified agency securities lending transactions, primarily by failing to take into account the risk mitigating benefits of correlations between asset classes.
- To address the punitive effects of the Comprehensive Approach, the RMA Committee offers three alternative approaches based on modifications to existing approaches with supervisory inputs; we are providing three alternatives to allow the Basel Committee flexibility in addressing this concern. The first approach, the Supervisory Inputs Approach, allows for correlations, but with supervisory rather than bank-based inputs, drawing primarily on stressed asset volatilities and correlations provided by supervisors. The second approach, the Revised Comprehensive Approach, is a revision to the Comprehensive Approach that incorporates a published matrix of haircuts developed by supervisors that takes into account the risk mitigating benefits of correlations between positions. The third approach, the Modified SA-CCR approach, modifies the recently adopted SA-CCR approach by mapping securities loans and collateral to their economically equivalent derivatives.
- Each of the approaches would be consistent with full regulatory visibility and control, and comparative consistency across institutions as well as provide greater risk-sensitivity through recognition of correlation and diversification between loaned and borrowed securities and collateral, or specific risk adjustments and other inputs.
- On a separate note, public disclosure of risk drivers should not be a prerequisite to the historically applicable 20% risk-weighting for securities firms. In no event should a regulated entity like a broker-dealer be subject to a higher risk-weighting than the 100% (or higher under the Consultative Document) risk-weighting to which exposures to unregulated corporations are subject.

I. Background on Agency Securities Lending Activities

A. Parties to securities lending transactions and nature of activities

Agency securities lending is a well-established, safe and sound activity that supports global capital markets activities and facilitates trade settlement.⁴ Supervisors have long recognized the importance of securities lending to financial markets and the overall economy. For example, the Basel Committee has found 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,” and the Financial Stability Board (the “FSB”) has found that agent lenders play an important role by helping beneficial owners access “economies of scale, securities lending expertise and systems . . . specialized market knowledge and better access to borrowers.”⁵ Securities lending increases global market liquidity and enhances price discovery by expanding the amount of securities available for financial activities. Most securities lenders are financial institutions, such as public and private pension funds, sovereign wealth funds, central banks, insurance companies, collective investment schemes such as undertakings for collective investment in transferable securities (“UCITS”) funds, and similar funds or entities. Securities borrowers largely consist of banks, broker-dealers and other financial institutions.

⁴ Securities lenders use agency securities lending services from Agent Banks in order to obtain additional incremental revenues. Agency securities lending activities developed initially as an outgrowth of Agent Banks’ custody and related activities, and have long been regulated, examined and treated by regulators as traditional banking services. *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for the growing securities lending industry); Letter from J. Virgil Mattingly, General Counsel, Board, William F. Kroener, General Counsel, Federal Deposit Insurance Corporation, and Julie L. Williams, General Counsel, Office of the Comptroller of the Currency (“OCC”), to the Securities and Exchange Commission (Dec. 10, 2002) (indicating that interagency guidelines “ensure that banks conduct their securities lending activities in a safe and sound manner and consistent with sound business practices, investor protection considerations and applicable law”); Bank of England, Securities Lending and Repo Committee, Securities Borrowing and Lending Code of Guidance (July 2009) (describing how securities lending transactions are regulated both under UK regulations and EU directives), *available at* <http://www.bankofengland.co.uk/markets/Documents/gilts/stockborrowing.pdf>; Directive 2004/39/EC, of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

⁵ *See* Basel Committee, *Securities lending transactions: market development and implications* (July 1999), *available at* <http://www.bis.org/publ/cpss32.htm>; FSB, *Securities Lending and Repos: Market Overview and Financial Stability Issues* 20-21 (Apr. 27, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120427.pdf.

Agent Banks act as intermediaries in securities lending programs by facilitating loans on behalf of securities lenders to qualified borrowers. Securities are generally lent pursuant to a (i) securities lending authorization agreement between the securities lender and the Agent Bank, and (ii) securities borrowing agreement between the borrower and the Agent Bank. Under these agreements, the borrower provides collateral to the securities lender (and generally, via its Agent Bank) in excess of the value of the loaned securities, usually by 2% to 12% depending upon the characteristics of the loaned securities and the collateral. The loan and collateral are then marked-to-market daily to ensure that the collateral consistently meets the requisite excess value.

At the end of the loan, the securities lender must return to the borrower the collateral pledged on the transaction. In periods when interest rates are more than *de minimis*, the securities lender pays the borrower a negotiated “loan rebate fee” on the cash collateral received. The securities lender receives all revenues accruing from the investment of the cash collateral pool (and, as described below, is responsible for all losses), less the borrower’s loan rebate fee. A fee is paid to the Agent Bank that is generally a percentage of the lender’s net revenue from the cash collateral pool less rebate rates paid on loans.

A diagram showing the structure of a typical securities lending transaction is attached as Exhibit A.

According to the RMA and Markit, a securities lending data service, approximately 66% loans of U.S. securities and 18% of loans of European securities (based on aggregate value on loan) use cash as collateral. Cash collateral is reinvested in securities, sometimes in collective investment vehicles or cash collateral pools. As of the fourth quarter of 2014, RMA data showed over \$1,127 trillion of loaned securities globally. RMA composite figures, compiled using responses of 15 member institutions, reflected \$8.93 trillion of U.S. lendable assets and \$4.34 trillion of non-U.S. lendable assets in the securities lending market for the fourth quarter of 2014. Of those assets, over \$572 billion of U.S. securities and \$129 billion of non-U.S. securities were on loan against cash collateral. Assets on loan remain substantially below peak levels achieved prior to the financial crisis. Based on data publicly disclosed in agent lender 10-Qs, as of December 31, 2014 loan balances have declined by over 52% since March 31, 2008, despite significant appreciation in major equity market indices during that same time period.

B. Borrower default indemnification by Agent Banks

As a matter of standard market practice developed over the past several decades, Agent Banks provide securities replacement guarantees, or indemnification for borrower default to the substantial majority of their lending clients pursuant to their securities lending authorization agreements. This practice is commonly referred to as “borrower

default indemnification.” The vast majority of lending clients (both U.S. and international) focus on risk avoidance and see the securities replacement guarantee as providing both protection to their programs and a validation of the strength of their Agent Banks’ risk management systems. Moreover, many lending clients (*e.g.*, U.S. clients subject to the Employee Retirement Income Security Act) are required under U.S. law to receive borrower default indemnification by an Agent Bank in their securities lending program under defined circumstances.⁶ Certain U.S. states and municipalities also require indemnification from the lending agent, either by statute or by policy, as a condition to their funds’ participation in securities lending.⁷ In addition, the Securities and Markets Stakeholder Group of the European Securities and Markets Authority (“ESMA”) has recommended that the securities lending agent be required to indemnify Exchange Traded Funds and other UCITS funds that loan securities.⁸

C. Impact of excessively limiting agency securities lending

As previously mentioned, Agent Banks acting as intermediaries (*i.e.*, the RMA Members) include some of the largest banks in the world. As the foregoing data demonstrates, these Agent Banks perform a function that is critical to the global

⁶ See Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63,786 (Oct. 31, 2006) (requiring in the case of securities lending transactions involving (i) certain types of foreign banks or broker-dealers as borrowers or (ii) certain types of collateral, including U.S. and non-U.S. securities, defined in the exemption as “Foreign Collateral,” that a U.S. bank or broker-dealer “Lending Fiduciary” indemnify the lending plan for borrower default).

⁷ See, *e.g.*, Texas Government Code § 825.303(b)(3) (stating that in order for a bank to be eligible to lend securities on behalf of a Texas Public Fund, the bank must “execute an indemnification agreement satisfactory in form and content to the retirement system fully indemnifying the retirement system against loss resulting from borrower default.”); New York State Teachers’ Retirement System Investment Policy Manual, Securities Lending Section 3 (October 2011), *available at* www.nystrs.org/main/library/IPM2011.pdf (requiring that the agent lender indemnify the System for losses resulting from a default by the borrower); New Mexico State Investment Council Securities Lending Policy (December 2006), *available at* http://www.sic.state.nm.us/PDF%20files/Section_15_Seclend_12142006.pdf (requiring that the Investment Office staff execute securities lending contracts that include: “At least the standard securities lending industry indemnification against borrower default.”); City Of Seattle Statement Of Investment Policy, *available at* <http://www.cityofseattle.net/executiveadministration/invpol.htm> (authorizing the Director of Executive Administration of the City of Seattle, “under the supervision of the Mayor and consistent with policy direction given by the Director of Finance, to invest all moneys in the City Treasury which in the judgment of the Director are in excess of current City needs in... providing indemnification against borrower insolvency.”).

⁸ See European Securities and Markets Authority, *Consultation paper: ESMA’s guidelines on ETFs and other UCITS issues*, ESMA/2012/44 42, 68, 75 (Jan. 30, 2012), *available at* <http://www.esma.europa.eu/consultation/Consultation-ESMA-guidelines-regulatory-framework-ETFs-and-other-UCITS-issues>.

economies. As discussed in the following sections, we believe the Standardised Approaches' "comprehensive approach" (the "Comprehensive Approach") to measuring exposure outlined in the Consultative Document would materially impair the agency securities lending activities of Agent Banks, specifically by requiring Agent Banks to overstate their exposure, thereby unduly limiting this critical avenue to providing market liquidity.

As to overstating the risk, in an informal survey of RMA members involved in the drafting of this letter: (i) many with the largest securities lending operations have never experienced any losses as a result of borrower-default indemnification; and (ii) none has incurred material losses as a result of the indemnification. Because of the daily mark-to-market and contractual protections provided in the securities lending agreements, as a practical matter, the true economic risk to a bank as a result of indemnification is that the borrower defaults immediately before a material intraday price movement in the loaned securities or collateral.

As to the impact on this vital market service, if the Basel Committee finalizes the Consultative Document as proposed, the result could be an interruption to or further compression of the securities lending market that could materially impair access to securities, driving down liquidity and in turn impeding price discovery. The loss in revenues associated with a continuing decline in securities lending would further reduce returns to government plans and other lending clients, who on average reap 80% to 85% of the revenues of agency securities lending transactions. The decline could also result in further disruptions in global settlement processes leading to increased rates of failed trades and similar disruptions, reduced availability of high-quality liquid assets to meet new swaps collateral⁹ and other regulatory mandates, and a shift of the securities lending business to non-banks who may fall outside the reach of risk-based capital rules. The combined effect of such events could potentially lead to vast disruptions in the capital markets at the very time market liquidity is critical to promoting economic stability in the United States and worldwide.

In addition, we urge the Basel Committee to consider carefully how any measure of exposure for regulatory capital purposes will affect other reforms to the regulatory framework governing agency securities lending activities that rely on the same overstated exposure measurement, *e.g.*, implementation of the framework for implementing large exposures and changes in European regulations governing exchange-traded and UCITS funds. These reforms already represent a significant and fundamental shift in the regulation of agency securities lending transactions, and care must be taken to ensure that any large exposure limit does not impose cumulatively negative impacts on the market.

⁹ According to Markit Group Data, \$2.4 trillion in government securities are currently available to lend, but availability to meet new derivatives collateral rules through lending programs could be limited.

Below, we offer our specific comments on the Consultative Document.

II. Technical Flaws in the Comprehensive Approach for Measuring Exposures

The Consultative Document proposes that banking organizations have two options for measuring collateralized exposures from agency securities lending transactions under the proposed revisions to the Standardised Approach: (i) the Comprehensive Approach, pursuant to which a banking organization would use internal or supervisory estimates to calculate haircuts; and (ii) the “simple approach”, which would allow a banking organization to replace the risk-weight of the borrower with the risk-weight of the collateral instrument collateralizing or partially collateralizing the exposure.

The RMA Committee shares the Basel Committee’s goal of ensuring that capital requirements reflect the inherent riskiness of exposures and that the Standardised Approach constitute a suitable alternative and complement to internal models.¹⁰ The RMA Committee recognizes that the Consultative Document seeks to strengthen the link between the Standardised Approach and the internal ratings-based approach, so as to enhance comparability of capital requirements across banks.¹¹ Furthermore, the RMA Committee also understands that the Basel Committee is in part guided by the principle that the Standardised Approach should not rely on internal modeled approaches or on external ratings and that the capital charge should be based on easily verifiable and objective variables set by regulators.¹²

The RMA Committee respectfully submits that, particularly for a long-proven safe and sound activity like agency securities lending, internal models are the most appropriate methodology for calculating exposures from agency securities lending transactions. Nonetheless, given the above-described views of the Basel Committee, this letter focuses on the Comprehensive Approach proposed by the Consultative Document and describes the ways in which it fails to appropriately quantify agency securities lending exposures in a manner consistent with the Basel Committee’s stated objectives, particularly in relation to the effects of correlation. This section of the letter describes these technical flaws, and the next section suggests ways to address these exposures that are more aligned with actual risk and also fully respond to the Basel Committee’s stated objectives in pursuing a Standardised Approach.

¹⁰ See Basel Committee, *Revisions to the Standardised Approach for credit risk 1* (Dec. 2014), available at <http://www.bis.org/bcbs/publ/d307.pdf>.

¹¹ See *id.*

¹² See *id.* at 5.

A. Non-risk sensitive haircuts; Negative Correlation

The Comprehensive Approach relies on a table of supervisory haircuts that vary with a number of factors, including the credit rating of the instrument, the identity of the issuer and the instrument's residual maturity. The proposed table of supervisory haircuts, however, lack both granularity and risk-sensitivity, in particular, by failing to take into account the effects of correlation between the securities loaned and collateral posted that are likely to exhibit themselves during times of stress. Instead, the Comprehensive Approach focuses solely on the perceived isolated volatility of each component of the exposure, and indeed assumes that the assets on loan are perfectly negatively correlated with the assets taken as collateral, specifically by requiring banking organizations to take a fixed negative haircut on the value of the loan exposure while taking a fixed positive haircut on the value of the collateral.

It would be extremely unrealistic to always assume that the price of the security lent would always rise with a fall in the price of the collateral during a time of stress, and for each instrument, always by the same fixed percentage. For example, a large systemic shock may cause prices across many asset classes to fall, causing the value of both securities loaned and collateral posted to fall simultaneously. Furthermore, the table of haircuts does not recognize the possibility of a "flight to quality" during times of stress, where certain classes of securities (*e.g.* equities and corporate bonds lent) would be expected to fall in price while the price of "safe" assets would be expected to rise (*e.g.* U.S. Treasuries collateral).

B. Foreign Exchange Haircut

The Comprehensive Approach requires banking organizations to take a 5.7% haircut adjustment to account for currency risk where the exposure and collateral are denominated in different currencies (based on a holding period of five business days and daily remargining).¹³ This fixed haircut for currency risk fails to differentiate between the wide range of historic volatilities between different currencies. In the same way that the supervisory haircuts do not take into account the correlation between different securities, the currency mismatch haircut fails to take into account any correlations in the values of certain currency pairs.

Instead, by providing a "one-size-fits-all" haircut for all currency mismatches, the Comprehensive Approach fails to be risk-sensitive and fails to accurately reflect the inherent risks of currency fluctuations. For example, the currency of many countries around the world is pegged to the U.S. dollar or the Euro. A haircut of 5.7% on a currency pair involving two currencies which are, as a matter of law or monetary policy, pegged to each other or another asset would be obviously inappropriate. Additionally,

¹³ See *id.* at 49.

and more broadly, data gathered from RMA members suggests that historically, for most currency pairs, the 5.7% haircut adjustment greatly overstates volatility by approximately double (assuming a five business day holding period).

The RMA Committee would support an approach that provided more granularity in the foreign exchange mismatch haircuts, for example, a multi-tiered approach that categorized currencies by volatility and provided for higher haircuts for more volatile currencies and lower haircuts for less volatile currencies. Accordingly, RMA Committee would be happy to work with the Basel Committee or any of its working groups to develop such an approach.

C. Lack of recognition of Diversification

The Comprehensive Approach assumes a perfect positive correlation among assets within an Agent Bank's securities loan portfolio and similarly among assets in its collateral portfolio by providing the same haircut for asset classes regardless of the composition of a portfolio and by assuming that the securities loaned will always increase in price while collateral will always decrease in price. This assumption fails to recognize the risk-mitigating benefits provided by portfolio diversification. In the same way that it would be unreasonable to assume that all securities lent and all collateral posted are perfectly negatively correlated across all asset classes, it would be equally inappropriate to assume that the price of assets on the same side of an exposure would move perfectly in sync with each other. In reality, an Agent Bank that maintains a well-diversified portfolio of loaned securities (or of collateral) is protected against shocks to specific asset classes. By failing to recognize the benefits of such diversification, the Comprehensive Approach fails to encourage Agent Banks to pursue a safe-and-sound practice. The RMA Committee would support an approach that recognized the potential for Agent Banks to reduce their potential exposure at default by diversifying the portfolio of securities loaned or collateral accepted.

III. Alternate Methodologies

Having described the technical flaws of the Comprehensive Approach, this section of the letter describes three alternative approaches to the Comprehensive Approach that the RMA Committee believes allow for appropriate recognition of correlations between securities loaned and collateral posted to secure the loan while also addressing Basel Committee's principles of simplicity, consistency, transparency, comparability, reduced volatility, risk-sensitivity, and supervisory control. While this Letter focuses on these three approaches, we would be happy to discuss with the Basel Committee or any of its working groups any similar approaches that also would allow for appropriate recognition of correlations.

The first approach, the Supervisory Input Models, attempts to provide a high level of transparency and regulator control while allowing for recognition of correlations by

providing individual volatilities and correlations between asset classes as supervisory inputs to the model. The second approach, the Modified Comprehensive Approach, which is a modification of the Comprehensive Approach that includes a matrix of haircuts also provides transparency with respect to supervisory input, but more closely resembles the Consultative Paper's Comprehensive Approach. Both the first and second approaches use the Basel Committee's existing haircuts as a foundation for the volatility inputs, in the case of the Supervisory Input Models, or the haircuts, in the case of Modified Comprehensive Approach, then expand the model to take into account the effects of correlation between asset classes; and finally adjust the factor inputs to account for flight-to-quality and wrong-way risk. The third approach, on the other hand, is a modification of the Basel Committee's standardised approach for measuring counterparty credit risk exposures ("SA-CCR"), the Revised SA-CCR, which may be preferable if the Basel Committee would prefer consistency and comparability across frameworks and if the Basel Committee would strongly prefer to work directly with a framework recently adopted in another context for economically equivalent exposures. Each proposal could be adopted in individual countries as a general framework that contemplates supervisory adjustment and calibration depending on market conditions; for example, the Basel III capital framework also provides for the imposition of a countercyclical capital buffer when "the risks of system-wide stress are growing markedly."¹⁴

A. Supervisory Inputs Approach

In order to provide a more risk-sensitive measure of an Agent Bank's exposure under agency securities lending, we urge consideration of an approach where Agent Banks are permitted to use *models recognizing correlations but with inputs provided by supervisors, i.e.*, an approach where supervisors have complete discretion to set model inputs, with the *only* variation between individual models arising from a firm's positions. Under the Supervisory Inputs Approach, supervisors would provide inputs to banking organizations, *e.g.*, haircuts, correlations between loaned and borrowed securities and collateral and specific risk adjustments.

Under the Supervisory Inputs Approach:

$$E^* = \max \left\{ 0, (E - C) + \sqrt{(E \cdot \delta_1)^2 + (-C \cdot \delta_2)^2 - 2 \cdot \rho_{1,2} \cdot (E \cdot \delta_1) \cdot (-C \cdot \delta_2)} \right\}$$

Where:

¹⁴ Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* 57 (Rev. June 2011), available at <http://www.bis.org/publ/bcbs189.htm>.

- E^* = the exposure value after risk mitigation
- E = the current value of the security lent
- δ_1 = the volatility of the security lent
- C = the current value of the collateral received
- δ_2 = the volatility of the collateral
- $\rho_{1,2}$ = the correlation between the lent security and the collateral

Each of δ_1 , δ_2 and $\rho_{1,2}$ would be standardized by regulators at an asset class level based on 99th percentile estimates under stressed scenarios. As discussed above, the volatilities are based on the Standardised Approach's current haircuts and calibrated to account for flight-to-quality and wrong-way risk.

As discussed in greater detail below, there are significant benefits to the Supervisory Inputs Approach, including (i) maintaining consistency and mitigating volatility of model outputs; (ii) better aligning exposure calculations with prudent risk management practices; and (iii) the ability to leverage existing risk management platforms, thereby avoiding significant cost and administrative burdens associated with changes to systems infrastructure.

First, consistent with an objective the regulators globally have begun to more aggressively pursue, the Supervisory Inputs Approach would allow supervisors to enhance comparative consistency and transparency and reduce volatility. Because inputs would be determined by supervisors and made uniform across institutions, regulators could easily calculate exposures for an individual institution and compare institutions to ensure proper capital charges and consistency of approach. The Supervisory Inputs Approach further offers the flexibility and control for regulators to adjust inputs to take into account specific risks, "flights to quality" and market stress events. Such an approach would also be consistent with other elements of the supervisory framework that contemplate adjustment and calibration depending on market conditions; for example, the Basel III capital framework also provides for the imposition of a countercyclical capital buffer when "the risks of system-wide stress are growing markedly."¹⁵

While providing all these benefits that are consistent with the Basel Committee's primary objectives, the Supervisory Inputs Approach would permit banking organizations to appropriately recognize the risk-mitigating benefits of correlations between asset classes, and thus would not penalize institutions for promoting prudent risk and exposure management practices by aggressively managing risk between loaned securities and collateral. For example, for certain equity securities loans, equity collateral may in fact be more correlated, and thus safer, than taking cash or Treasuries as collateral, yet the

¹⁵ Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* 57 (Rev. June 2011), available at <http://www.bis.org/publ/bcbs189.htm>.

Comprehensive Approach would penalize and thus discourage this safe and sound behavior. In sum, although the Supervisory Inputs Approach would not have the same level of precision (or accuracy) with respect to correlations as an internal models approach, it would take into account at least some level of correlation between asset classes, thereby more accurately and precisely reflecting exposures arising from agency securities lending activities while still achieving supervisory objectives of consistency, transparency and reduced volatility.

B. Revised Comprehensive Approach Using A Matrix

To the extent the Basel Committee continues to favor a haircut-based methodology substantially similar to the Comprehensive Approach rather than an approach that directly takes correlations as inputs as in the Supervisory Inputs Approach, the RMA Committee also submits that the Basel Committee should support a Revised Comprehensive Approach that implements a matrix of haircuts published by supervisors based on combinations of loaned securities and collateral received that reflects correlations between positions, and therefore more accurately reflects counterparty exposure.

Under the Revised Comprehensive Approach:

$$E^* = \max\{0, E \cdot (1 + h_{e,c} - h_c) - C \cdot (1 - h_c - h_{fx(e,c)})\}$$

E^* = the exposure value after risk mitigation

E = the current value of the security lent

$h_{e,c}$ = the haircut for the loan/collateral combination based on correlations under a stressed scenario

C = the current value of the collateral received

h_c = the haircut for the collateral/cash combination based on correlations under a stressed scenario

$h_{fx(e,c)}$ the haircut for the collateral currency, if applicable¹⁶

The haircuts would be calculated according to a matrix similar to the following:

¹⁶ As discussed in Section II.B above, the RMA Committee stands ready to work with the Basel Committee or its working groups to devise a more granular approach for currency mismatch haircuts.

Haircut Percentages	Cash	0% Weighted Sovereigns <1 year	0% Weighted Sovereigns 1 year < 5 years	0% Weighted Sovereigns > 5 years	20% - 50% Weighted Sovereigns <1 year	20% - 50% Weighted Sovereigns 1 year < 5 years	20% - 50% Weighted Sovereigns > 5 years	Corp/Muni	Corp/Muni	Corp/Muni	Equity
Cash	0.0%	0.1%	1.2%	2.8%	0.5%	2.1%	6.7%	1.2%	6.9%	13.7%	15.0%
0% Weighted Sovereigns <1 year	0.6%	0.5%	1.2%	2.4%	0.7%	1.9%	5.2%	1.1%	5.1%	9.9%	12.3%
0% Weighted Sovereigns 1 year < 5 years	1.6%	1.2%	2.1%	3.3%	1.6%	2.8%	6.2%	1.8%	6.0%	11.2%	14.0%
0% Weighted Sovereigns > 5 years	2.8%	2.1%	3.0%	4.1%	2.4%	3.5%	7.0%	2.7%	7.1%	12.0%	14.8%
20% - 50% Weighted Sovereigns <1 year	0.9%	0.7%	1.6%	2.7%	1.1%	2.3%	5.6%	1.4%	5.4%	10.1%	12.0%
20% - 50% Weighted Sovereigns 1 year < 5 years	2.1%	1.6%	2.5%	3.5%	2.0%	3.2%	6.5%	2.2%	6.4%	11.2%	13.0%
20% - 50% Weighted Sovereigns > 5 years	1.8%	1.4%	2.3%	3.4%	1.7%	2.9%	6.4%	2.0%	6.4%	11.3%	13.1%
Corp/Muni	1.7%	1.2%	1.9%	3.0%	1.4%	2.5%	5.6%	1.7%	5.4%	10.2%	12.0%
Corp/Muni	1.6%	1.2%	2.0%	3.2%	1.5%	2.7%	6.1%	1.8%	5.7%	10.9%	13.3%
Corp/Muni	3.3%	2.4%	3.3%	4.4%	2.6%	3.9%	7.3%	3.0%	7.3%	12.1%	15.0%
Equity	6.2%	5.0%	6.2%	7.5%	5.0%	6.3%	9.9%	5.3%	10.4%	16.2%	11.8%

As noted above, the proposed haircuts are based on the haircuts implemented in the current Standardised Approach, adapted to account for correlation between asset classes and then calibrated to account for flight-to-quality and wrong-way risk.

Similar to the supervisory inputs approach, a matrix that takes into account correlations between positions should produce haircuts that more accurately reflect underlying risks and exposures associated with agency securities lending transactions, allowing banking organizations to realize at least some of the benefits associated with correlations between positions. Also like the Supervisory Inputs Approach, the Revised Comprehensive Approach would rely on inputs determined by supervisors and made uniform across institutions, enhancing comparability and transparency. Furthermore, like the Supervisory Inputs Approach, the Revised Comprehensive Approach would offer regulators the flexibility to adjust inputs to take into account specific risks, “flights to quality” and market stress events.

The RMA Committee stands ready to assist the Basel Committee or any of its working groups with any necessary analysis needed to develop such a matrix and firmly believes that such an approach could help further the Basel Committee’s supervisory objectives.

C. Adopting SA-CCR

In April 2014, the Basel Committee finalized revised standards that included a comprehensive, non-modeled approach for measuring counterparty credit risk associated with OTC derivatives, exchange-traded derivatives and long settlement transactions.¹⁷

¹⁷ Basel Committee, *The standardised approach for measuring counterparty credit risk exposures* (Apr. 2014), available at <http://www.bis.org/publ/bcbs279.pdf>.

The new approach, known SA-CCR, replaced the “Current Exposure Method” and the “Standardised Method” and, for collateralized OTC derivatives transactions, is being proposed unmodified in the Consultative Document. If the Basel Committee does not find either the Supervisory Inputs Approach or the Revised Comprehensive Approach acceptable, or would prefer consistency and comparability across frameworks, the RMA Committee proposes that the SA-CCR be modified and adopted for agency securities lending transactions by mapping loan and collateral asset classes to one or more existing SA-CCR asset classes. As mentioned above, such a mapping would have the benefit of creating similar capital charges for transactions with similar economic exposures and would have the benefit of consistency of across frameworks.

Under SA-CCR:

$$EAD = \alpha \cdot (RC + PFE)$$

Under the Modified SA-CCR, the Replacement Cost (RC) would be set to zero since the risk to Agent Banks under agency securities lending resides primarily in the margin period of risk between default and indemnification (due to the daily mark-to-market and contractual protections provided in the securities lending agreements), which is captured by PFE:

$$EAD = \alpha \cdot PFE$$

$$\begin{aligned} \alpha &= 1.4 \\ PFE &= \text{the amount of potential future exposure} \end{aligned}$$

Loan exposures would be treated as a short exposure and the credit risk mitigating effect of collateral would be factored in by treating collateral as a long exposure. Equity securities would be mapped to equity derivatives, fixed income securities would be mapped to interest rate and credit derivatives, and loan/collateral settlement currency mismatches would be mapped to foreign exchange derivatives. Any applicable maturity adjustment would be set at five (5) days for liquid exposures and twenty (20) days for illiquid exposures, consistent with the current treatment for securities finance transactions.

Like the proposed Supervisory Inputs Approach and Revised Comprehensive Approach set forth above, the Modified SA-CCR approach reflects underlying risks and exposures associated with agency securities lending transactions more accurately than the Comprehensive Approach by recognizing potential correlations between positions. If for whatever reason the Basel Committee does not find the Supervisory Inputs Approach or the Revised Comprehensive Approach satisfactory, this Modified SA-CCR approach also has the benefit of using a methodology consistent with that already set forth by the Basel Committee in similar contexts; this is thus clearly a methodology acceptable to the Basel

Committee, and also would allow the Basel Committee to achieve greater levels of consistency across products.

IV. Risk-Weight for Securities Firms

We note that historically and under the current Standardised Approach, exposures to securities firms can be classified as exposures to banks and risk-weighted at 20%, provided that the securities firms are subject to consolidated regulation and supervision with respect to any downstream affiliates.¹⁸ Recently, however, some jurisdictions have eliminated the special classification for securities firms, treating such exposures as general corporate exposures, risk-weighted at 100%.¹⁹ Similarly, in order to qualify for the favorable 20% risk-weight under the Consultative Document, in addition to satisfying the existing requirements related to consolidated regulation and supervision, the securities firm must publicly disclose certain risk drivers relating to its capital adequacy and asset quality. Exposures to securities firms that do not satisfy these requirements must be risk-weighted as general corporate exposures, whose risk-weights could range up to 300%.²⁰ Since, in many countries, regulatory risk drivers for broker-dealers and other securities firms are not publicly disclosed, the practical effect of this requirement would be that exposures to such firms would be risk-weighted similarly to general corporate exposures.

The RMA respectfully submits that in no event should a regulated entity like a broker-dealer be subject to a higher risk weighting than the 100% (or more under the Consultative Document) risk-weighting to which potentially unregulated corporations are subject. Moreover, if a broker-dealer is a consolidated affiliate of a highly regulated banking institution, which is subject to increasingly stringent capital, liquidity and other requirements, we submit that a much lower risk-weight, *i.e.* the 20% risk weight to which they have historically been subject, would be more appropriate and would more accurately reflect the risk profile of such firms.

V. Conclusion

We thank the Basel Committee for the opportunity to comment on the Consultative Document and participate in the ongoing dialogue on measuring exposure for agency securities lending transactions. We look forward to continued dialogue with the Basel Committee and other supervisors and believe, as the Basel Committee does,

¹⁸ See Basel Committee, *International Convergence of Capital Measurement and Capital Standards* (rev. Apr. 1998), available at <http://www.bis.org/publ/bcbasc111.pdf> (Annex 2).

¹⁹ See, e.g., 12 C.F.R. 217.32.

²⁰ See Basel Committee, *Revisions to the Standardised Approach for credit risk* 6 (Dec. 2014), available at <http://www.bis.org/bcbs/publ/d307.pdf>.

that achieving effective and efficient reform requires healthy and robust collaboration between supervisors and market participants. As the Basel Committee considers our comments and those of other market participants, we emphasize that effective regulation requires robust cost-benefit analysis and thorough consideration of whether perceived benefits of regulatory changes outweigh the costs imposed on individual firms and the overall economy. In this regard, we believe that the impact of the restrictive and risk-insensitive measures of exposure for agency securities lending transactions under the Comprehensive Approach have the potential to significantly decrease the amount of securities on loan and negatively (and unduly) impact overall market liquidity. Similarly, we believe that the requirement that public disclosure of risk drivers be a prerequisite to the historic 20% risk-weighting for securities firms does not accurately reflect the risk characteristics of many regulated securities firms and that the requirement should not be implemented as proposed. We submit that the Standardised Approach should continue to recognize the historic 20% risk-weight for appropriately regulated securities firms, particularly those that are affiliates of highly regulated banks.

As to the suggested alternatives to the Comprehensive Approach for calculating exposures for agency securities lending transactions described in Section III of this letter, the RMA Committee is aware of recent speeches by certain regulators regarding the perceived systemic risks presented by securities financing transactions, particularly with respect to the perceived volatility of securities financing activities as a short-term funding market vulnerable to “runs.”²¹ We strongly disagree with the suggestion that properly conducted and structured agency securities lending transactions present heightened risks to financial stability; to the contrary, agency securities lending transactions are recognized as well-established, safe and sound activities that rarely produce significant losses to entities involved in the program and are unlikely to lead to systemic concerns. As stated above, there have been no material losses among the major agent banks as a result of indemnification, including the environment immediately following the default of Lehman Brothers. Nonetheless, if regulators wish to affirmatively address any perceived macroeconomic concerns, such concerns could be more than adequately addressed by the three proposed approaches described in Section III, which as discussed above allow supervisors to impose substantially similar haircuts across institutions, thereby ensuring that volatility in calculated exposures from agency securities lending transactions would be mitigated and inputs could be appropriately calibrated and, if necessary, adjusted to take market stress into account. The RMA Committee thus submits that the approaches proposed in Section III would more than adequately address any perceived volatility or “run risk” arising from agency securities lending transactions, and urges the Basel Committee to actively consider the merits of these approaches.

²¹ See, e.g., Daniel K. Tarullo, Governor, Fed. Reserve Sys., Remarks at the Peterson Institute for International Economics: Evaluating Progress in Regulatory Reforms to Promote Financial Stability (May 3, 2013); Janet L. Yellen, Vice Chair, Fed. Reserve Sys., Regulatory Landscapes – a US Perspective, Speech at the International Monetary Conference (June 2, 2013).

We strongly believe our three proposed alternatives to the Comprehensive Approach described in Section III both are fully consistent with the Basel Committee's stated objectives in pursuing the Standardised Approach, and also allow for at least some recognition of correlations--thereby more accurately aligning regulatory and actual risk and encouraging safe and sound behavior (because, as stated above, a securities loan with correlated securities collateral in many cases actually poses less risk to an Agent Bank than a loan with uncorrelated cash or Treasuries as collateral). A lower risk in these transactions also results in lower systemic risk to the global economy. We also believe that our proposal relating to the appropriate risk-weighting for securities firms is consistent with economic risk of such firms. The RMA Committee would be pleased to discuss this letter in further detail, and stands ready to assist the Basel Committee as it continues to consider revisions to the Standardised Approach.

Sincerely,

Fran Garritt

Director
Securities Lending & Market Risk
Risk Management Association

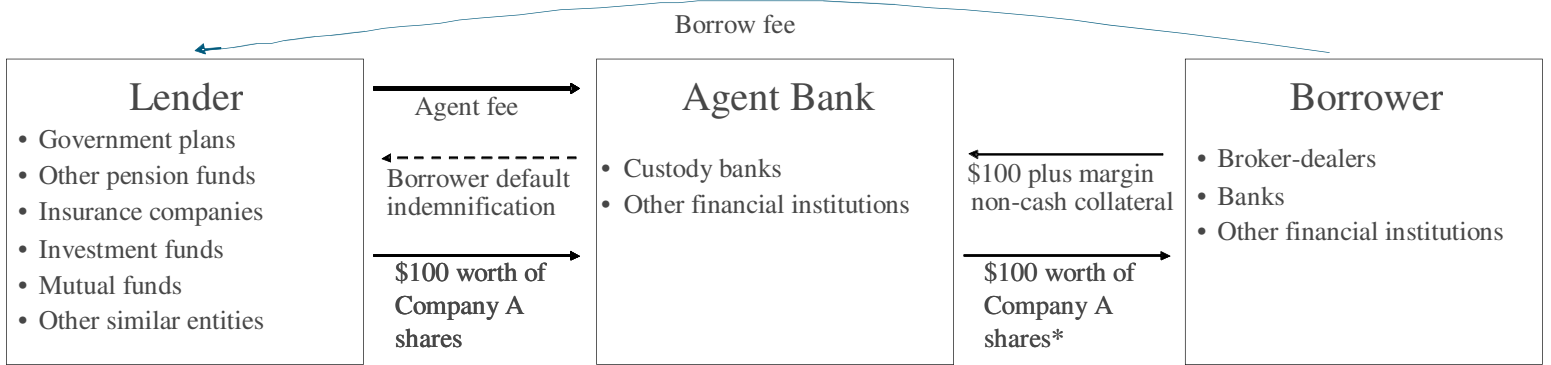
Jason P. Strofs

Chairman
Committee on Securities Lending
Risk Management Association

cc: Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

EXHIBIT A

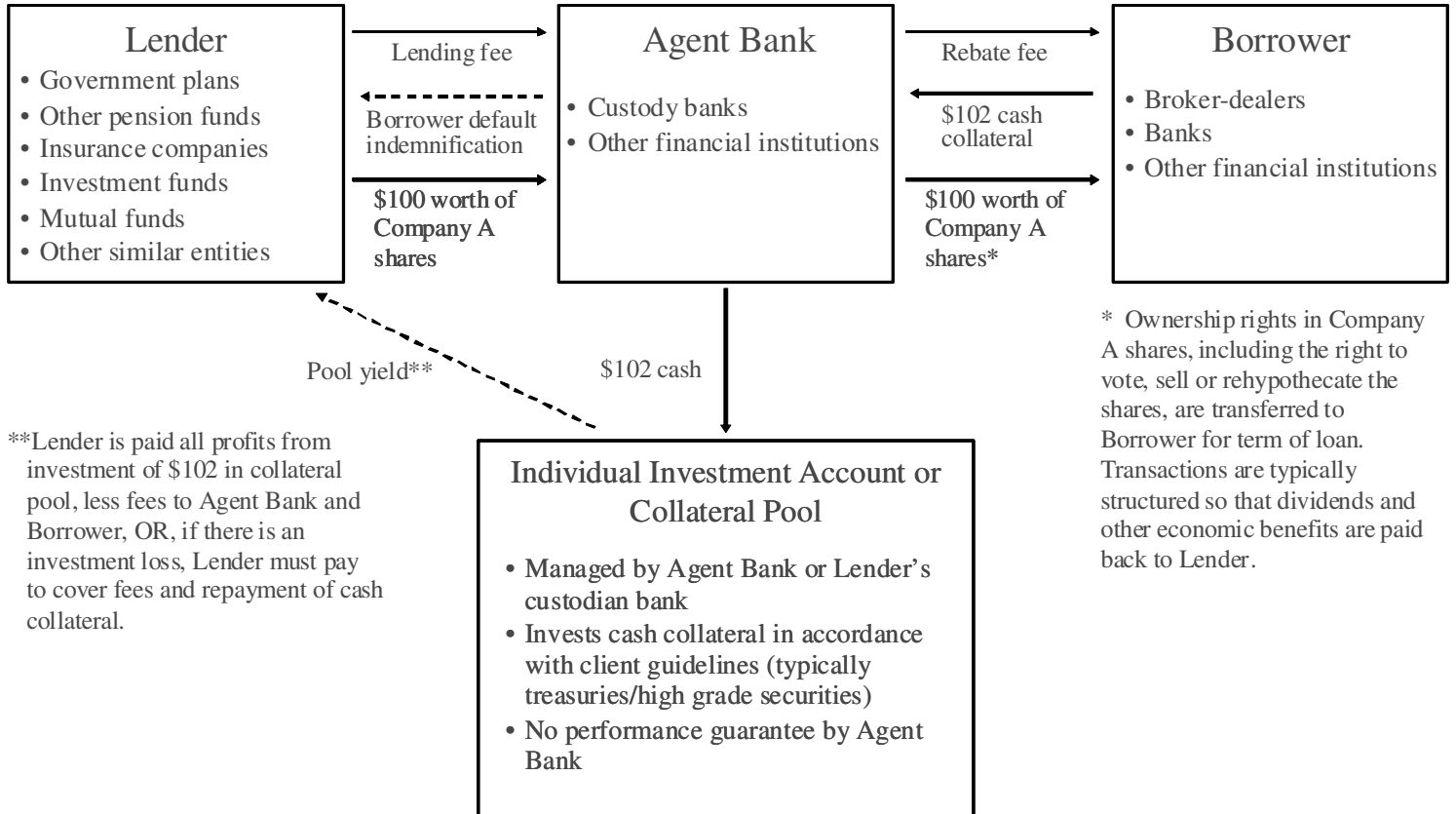
**Typical Securities Loan Structure
(Non-Cash Collateral)**



* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.

EXHIBIT A

**Typical Securities Loan Structure
(Cash Collateral)**



**Lender is paid all profits from investment of \$102 in collateral pool, less fees to Agent Bank and Borrower, OR, if there is an investment loss, Lender must pay to cover fees and repayment of cash collateral.

* Ownership rights in Company A shares, including the right to vote, sell or rehypothecate the shares, are transferred to Borrower for term of loan. Transactions are typically structured so that dividends and other economic benefits are paid back to Lender.