

Prudential Treatment of SFT counterparty risk under Standardised approach

ICMA ERCC Position Paper

Background: CRR3

The new EU banking package published in October 2021 implements the Final Basel III into banking regulation in the form of the Capital Requirements Regulation (CRR3)¹ and the Capital Requirements Directive (CRD6). One of the key elements of the Final Basel III framework is a more granular but less sensitive recalibration of the credit risk (CR) weighting calculations under the Standardised Approach (SA). This is particularly punitive in the case of securities financing transactions (SFTs) since it does not recognize the relatively short-term nature of SFTs in the case of exposures to non-banks. Accordingly, this results in the Risk Weighted Asset (RWA) computations for SFTs with many key market participants under the SA being multiples of those calculated under banks' Internal Model Approach (IMA).

This contrasts to the treatment of short-term SFT exposures to banks for which Final Basel III recognises their lower risk. There is no explanation as to why short-term exposures with non-banks are treated less favourably.

Banks that rely on IMA do have more flexibility in adjusting RWAs for SFTs to account for both internal ratings and the relatively short maturities of the underlying transactions. However, Final Basel III also introduces the output floor (OF), which sets a minimum for capital requirements calculated under banks' IMAs at 72.5% of those required under the SA. In the case of SFTs, the unequal treatment for RWAs under the SA will be problematic for banks that use either the SA or the IMA, with considerable impacts for SFT capital requirements. In turn, this will affect the cost of offering this service, as well as liquidity in the related securities markets, since SFTs are instrumental in supporting market-making. This will not only impact securities investors such as insurance and pension funds, but also securities issuers, including corporates and sovereigns.

This comes at a time when the ability of many different investors to access the repo market on a consistent basis is very much in the spotlight, as are concerns about dislocations in the eurozone sovereign bond market following the wind-down of the ECB purchase programmes, as well as reduced liquidity in corporate bond markets. Making short-term repo markets more expensive and less liquid for critical market participants, including market-makers, seems counterintuitive.

The ICMA ERCC would therefore propose that the RWA calculation for short maturity SFTs under the SA be adjusted to reflect better their short-term nature and relative importance to overall market functioning. This would also be consistent with other aspects of the SA that take into account the short-term nature of certain exposures.

¹ [2021/0342\(COD\)](#)

Potential impact on an SFT (illustration purposes only)

When implementing both the exposure at default measurement and the applicable risk weights under the SA, the difference in the RWA calculation compared to that under the IMA can be several times higher (up to x8 according to some simulations). Applying the 72.5% OF to this subset of exposures would still give rise to a significant differential (up to x6), which would need to be met with an additional capital valuation adjustment (KVA).² The following example illustrates the issue. It is based on assumptions that were deemed realistic by a sample of large EU banks.

Example

- Assume the RWA calculation for an SFT under the SA is 80% (this would assume a mix of 0% RW sovereign, 20% RW investment-grade banks and 100% RW other counterparties for the most part).
- Assume that under the IMA this is 15%
 - Applying the OF in the IMA leads to a rise in the RWA calculation of 43% $[(72.5\% \times 80\%) - 15\%]$
- Assume a targeted return on capital for SFTs of 15%
- Assume an applicable own funds requirement³ of 10.5%
- Assume a standard haircut on the SFT of 5%, which includes the supervisory volatility adjustment (adjustment for collateral slippage risk in case of counterparty defaulting): this is the unsecured percentage of the transaction that is used for SFT credit risk.
 - Applying the OF leads to an additional capital valuation adjustment (KVA) of 3bp (see below). If starting RW under SA were 100%, then capital valuation adjustment would be 5bp.

Stand Alone Output Floor Impact on SFT	
(i) INDICATIVE average IMA RW	15%
(ii) INDICATIVE average SA RW	80%
(iii) Output Floor	72,50%
(iv) Impact from IMA to Output Floor $[(ii) \times (iii) - (i)]$	43%
(v) ASSUMED Own Funds requirement	10.5%
(vi) ASSUMED Target ROE on SFT activities	15%
(vii) INDICATIVE Haircut (incl. supervisory adjustments)	5%
$(iv) \times (v) \times (vi) \times (vii) =$	0,03%
Capital Value Adjustment [KVA] on SFT	

While 3bp may not appear significant, in the context of sovereign bond repo where bid-offer spreads usually range between 5bp and 10bp, this is a very punitive additional cost, which will either have to be absorbed by the bank, or, more likely, to be passed on to non-bank counterparties (such as pension funds or money market funds) through a price adjustment. This is also likely to have the

² The KVA is a capital adjustment for regulatory capital that must be held by the bank during the life of the transaction

³ The own funds requirement is the sum of a bank's Common Equity Tier 1 Capital, Additional Tier 1 Capital, and Tier 2 Capital: 10.5% would be an absolute minimum in the EU

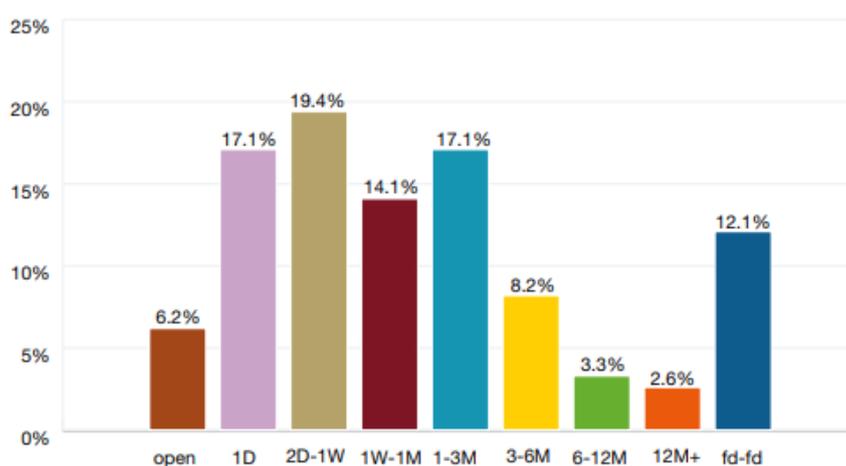
unintended consequence of negatively impacting dealer capacity for liquidity provision while also reducing counterparty diversity.

Importance of SFT markets

SFTs, in particular sovereign bond repos, serve multiple purposes that are fundamental not only to capital market functioning and integrity, but also to the broader economy. This includes liquidity and collateral management, supporting market-making in the underlying securities, and facilitating monetary policy.⁴

The December 2021 ERCC Euroean Repo Survey⁵ estimates the outstanding size of the European repo market to be EUR 9.2 trillion. The Survey further estimates that 91% of outstandings are in sovereign bonds, while 73.8% of outstandings have a maturity \leq 3 months (see below figure).

Maturity profile of European repo market (ERCC European Repo Survey December 2021)



Policy recommendation

For the CRR3 implementation, the ICMA ERCC calls for the introduction of a maturity adjustment under SA-CR for short-term SFTs (\leq 3 months maturities) with non-banks. Specifically, the 20%-30% Risk Weights for banks' short-term exposures should extend to non-bank exposures. This would not only be important from the perspective of recognising the importance of SFT markets for the wider functioning of capital markets, but it would be consistent with other aspects of CRR2 and CRR3 that take into account maturity sensitivities in the SA (see preferential treatment for less than three-month exposures on banks, debt with short-term ratings available for corporates and institutions, or self-liquidating trade finance transactions in the banking book).

⁴ For a more detailed account, see: <https://www.icmagroup.org/market-practice-and-regulatory-policy/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/3-what-is-the-role-of-repo-in-the-financial-markets/>

⁵ See: <https://www.icmagroup.org/assets/European-Repo-Market-Survey-April-2022.pdf?vid=4>

The short-term nature of SFTs is also already factored in other parts of the CRR as evidenced by current preferential risk-weight as per:

- Foundation IRB: a specific 6-month maturity is assigned to *exposures arising from repurchase transactions or securities or commodities lending or borrowing transactions*, rather than 2.5 years that applies to all other exposures [CRR article 162(1)] where the maturity value is not calculated as set out in the second paragraph of CRR Article 162
- Advanced IRB approach: for *repurchase transactions or securities or commodities lending or borrowing transactions which are subject to a master netting agreement*, a maturity floor is set at 5 days only instead of 1 year [CRR Article 162(2)(d)]