The following is the response submitted to the European Commission’s public consultation on Implementing the final BASEL III reforms in the EU (January 2020)

2. SECURITIES FINANCING TRANSACTIONS (SFTS)

2.1. MINIMUM HAIRCUT FLOORS FOR CERTAIN SFTS

Issue: The Basel III standards introduce a minimum haircut floors framework for non-centrally cleared SFTs in which institutions provide financing to non-banks against collateral other than government securities (‘in-scope SFTs’). Under this framework, institutions that engage in those SFTs are required to receive from non-banks a minimum amount of over-collateralisation. SFTs that do not comply with the minimum level of collateralisation would be subject to a more conservative capital requirement against counterparty credit risk, i.e. treated as unsecured loans to the respective counterparty (in other words, the mitigating effect of any collateral received would not be recognised). The introduction of minimum haircut floors in the Basel framework would limit the amount that non-banks can borrow against different categories of securities. This in turn, should restrain the build-up of excessive leverage outside of the banking system and reduce the procyclicality of that leverage. An alternative option recommended by the Financial Stability Board (FSB) in 201519 to meet these prudential objectives would be to introduce minimum haircut floors for in-scope SFTs via a market regulation. In this case, institutions would no longer be allowed to conduct those SFTs below the minimum haircut floors. A market regulation would ensure a level-playing field for all market participants should the Union decide in the future to introduce a similar market regulation for in-scope SFTs between non-banks, as also recommended by the FSB.

112) How do you view the potential effectiveness of minimum haircut floors with regard to achieving their prudential objectives? Would the incentive provided by the framework be sufficient to encourage institutions to meet the minimum level of over-collateralisation?

The ERCC appreciates the objective of the FSB framework¹ to limit the possible build-up of leverage outside the banking system and reduce the procyclicality of that leverage. The ERCC further recognizes that the framework is intended to serve as a backstop in benign market conditions and is not intended to deter market participants from determining their own appropriate, more granular haircut schedules.

However, there are a number of considerations in relation to which the framework appears to be overly punitive or unhelpfully complex, and that potentially undermine its effectiveness.

These considerations are outlined in the GFMA and ICMA Repo Market Study, published in December 2018, and which are re-cited below.²

**Disproportionate impact on risk weightings**

The FSB recommends that the BCBS should set significantly higher capital requirements for transactions with haircuts below the numerical haircut floors, with the goal of creating incentives for banks to set their collateral haircuts higher than the floors rather than to hold more capital.

The ERCC would support an appropriate incentive for firms to set haircut schedules that are at least in keeping with, if not more conservative than, the minimum haircut floors. However, the Basel III³ treatment whereby in-scope SFTs which do not meet the haircut floors must be treated as unsecured loans to their counterparties, is overly punitive. The ERCC would argue that no recognition of the risk-mitigating benefits of any collateral that is assigned to the transaction is disproportionate and would essentially make transactions that are contingent upon a haircut below the floor economically unviable. In these scenarios it is more likely that trades will not be executed, rather than haircuts being renegotiated (see Question 113). This could suppress market activity for certain asset classes, with unintended consequences for market liquidity and stability.

**Netting anomalies**

The Basel III haircut framework incorporates a mechanistic netting formula, which in some cases leads to anomalous results. In certain scenarios it would cause a transaction that on its own would meet the requirements to rather be treated as non-compliant because of the netting calculation. This approach fails to consider and capture the range of legitimate factors that influence asset and liability collateralization practices.

The below illustrates anomalous outcomes resulting from the application of the portfolio netting formula.

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² *The GFMA and ICMA Repo Market Study: Post-Crisis Reforms and Evolution of the Repo and Broader SFT Markets, December 2018*

³ *Basel III: Finalising post-crisis reforms, BCBS, December 2017*
A more appropriate approach would be to develop a multi-step supervisory review process. Such an approach would consider the degree of under-collateralization in an SFT, with enhanced capital requirements scaled in proportion to the size of the shortfall. This approach would both apply a penalty and incentivize proper risk management around the resulting exposure.

Regulated counterparties

The minimum haircut framework focuses particularly on preventing the build-up of leverage to the non-regulated sector. It achieves this by imposing minimum haircuts on the provision of financing through
SFT transactions which are not centrally cleared and in which the counterparty is a non-regulated entity. However, the description used to designate non-regulated entities—“counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international norms”—is not clear and, in practice, would be restrictive and not allow for the exemption of SFTs between banks and appropriately regulated counterparties. Such counterparties may include broker-dealers, insurance companies, pension funds, 40 Act mutual funds in the US, EU regulated UCITs, and other similarly structured open-ended funds. This approach may include in the framework entities with a sufficiently robust regulatory overlay which specifically prevents the build-up of excessive leverage.

A more targeted approach would specifically and clearly exempt entities that are already regulated and that have regulatory restrictions on leverage. This would better target transactions with the non-regulated sector that could contribute to the build-up of excess leverage.

113) Would the introduction of minimum haircut floors particularly affect certain types of in-scope SFTs or certain counterparties with which institutions conduct in-scope SFTs? If so, which effects would you expect and how could prudential regulation address them?

While the ERCC appreciates the objective of the minimum haircut floors to reduce the build up of leverage outside of the banking system, the provisions do not sufficiently differentiate between SFTs that are executed solely for the purpose of financing (which increase leverage) and those that are executed for other reasons, in particular borrowing and lending activity in specific securities. These transactions are essential in supporting market-making activity, where liquidity providers are required to make short sales to service their clients, while also ensuring settlement efficiency. Facilitating short sales in cash securities is also essential for maintaining derivatives market liquidity and price efficiency.

Repo and securities financing desks rely heavily on the ability to borrow specific securities through the securities lending market. Lenders, who are non-banks, are only incentivized to enter the market (i) by the potential to make marginal additional returns on lending assets held in their portfolio and (ii) a high degree of protection in the event of counterparty default. An important component of the latter is the ability to apply an appropriate haircut on their borrowing counterparty (invariably banks). This model, while integral to market liquidity and functioning, by its very nature falls short of the minimum haircut floor requirements and, as calibrated in Basel III, would mean that all such transactions would be treated as unsecured loans.

GFMA and ICMA undertook analysis of the potential impact if the SFT minimum haircut floors and concluded that the framework would increase SFT RWAs by 61% under the advanced approach and 63% under the standardized approach, with 52% and 57% of the impact respectively coming from securities borrowing. In reality, this is likely to result in a significant decrease in lending and repo activity.

The FSB framework and Basel III provisions do provide exemptions where lenders of securities meet certain strict reinvestment requirements, or provide representation to that effect, in the case of cash collateral, or can provide representations that the collateral will not be re-used in the case of non-cash collateral. However, the practicalities of such cash and non-cash collateral segregation and the associated attestation requirements may prove to be challenging for many securities lenders, leading them to withdraw from the securities lending market, negatively impacting market depth and liquidity.
114) Would you deem further clarifications necessary, for instance, concerning the scope of application of the framework or the formulas that identify in-scope SFTs non-compliant with the minimum haircut floors? If yes, please specify.

The ERCC would concur with the EBA recommendation

for the Basel III exemption for minimum haircut floors in the case of non-cash collateral (paragraph 183) be clarified to reflect better the intent of the FSB framework:

**Banks’ counterparties that lend securities (to the bank) are exempted from the haircut floors on collateral upgrade transactions — or securities borrowing/lending transactions against the pledging of other securities as collateral, rather than cash — if they (i.e. the banks’ counterparties) are unable to reuse, or provide representations that they do not and will not reuse, the securities received as collateral against the securities lent.**

The ERCC would further request for clarification that in the case of SFT structures where the collateral received by the lending party cannot be reused (such as in the case of “pledge structures”), this would be deemed equivalent to the requirement for representation that the collateral will not be reused.

115) As an alternative option to implementing minimum haircut floors for in-scope SFTs in the prudential framework as provided by the Basel III standards, such floors could be implemented via a market regulation. How would you compare the two alternative options in terms of achieving the prudential objectives? Would one of the two options affect more significantly the SFTs market? Please provide relevant evidence to substantiate your views.

The ERCC would support the approach to implementing the Basel III standards for minimum haircut floors through market regulation. This should help support consistency and harmonization of application across the EU.

116) In your view, which other aspects, if any, should be considered in the context of the possible implementation of minimum haircut floors in the Union? Please specify and provide relevant evidence.

The ERCC would urge the European Commission to review the already outlined potential unintended consequences of the minimum haircut floor framework, particularly with respect to market liquidity, efficiency, and stability, in light of the objectives of the CMU. As outlined in the 2017 report of the European Commission’s Expert Group on Corporate Bond Markets,

functioning, liquid repo and securities lending markets are a vital component in establishing an integrated, efficient, and resilient EU corporate bond market.

To that end, the ERCC would further concur with the EBA recommendation of taking a cautious approach before proceeding with the implementation in the EU of the minimum haircut floors framework in the EU. The ERCC would agree that further quantitative analysis of the potential impacts

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4 Policy Advice on the Basel III reforms on Securities Financing Transactions (SFTs), EBA, August 2019
5 Improving Corporate Bond Markets, Report from the Commission Expert Group on Corporate Bonds, November 2017
of the framework on lending and borrowing activity is required, as well as an assessment of the consequences for broader capital market functioning and efficiency.
2.2. OTHER REVISIONS TO THE CALCULATION OF THE EXPOSURE AT DEFAULT FOR SFTS

Issue: The final Basel III standards revised some methods to calculate the exposure value for counterparty credit risk (CCR) arising from SFTs. The main changes include (i) the recalibration of supervisory haircuts; (ii) the removal of the use of own estimates of collateral haircuts and (iii) amendments to the formula for the calculation of the exposure value of SFTs covered by a master netting agreement. In addition, the ‘Repo-VaR’ approach (internal models approach for master netting agreement under CRR) would no longer be permitted where institutions use the Standardised Approach for Credit Risk to assess the risk weights of their counterparties. Some of these revisions seek to enhance the risk-sensitivity of the methods used to calculate the SFTs exposure value for CCR. Others simplify these methods and improve the comparability across institutions. Incorporating the amendments into Union law would require a number of limited amendments to the CRR.

117) What are your views on the expected effects of these revisions with regard to risk sensitivity, recognition of netting, impact on RWAs and comparability across institutions? Please provide relevant evidence to substantiate your views.

The Basel III treatment of risk weightings for SFT exposures to banks under the standardised approach (SA) provides an adjustment for short-term exposures (< 3months). The SA, however, does not provide for maturity sensitivity in the case of SFT exposures with non-banks. This overlooks the predominantly short-dated nature of the SFT markets (see graphic) and the inherent safety of short-dated collateralized transactions. This is likely to prove to be an unintended deterrent to banks transacting in SFTs with non-banks, potentially restricting access to key participants, such as pension funds, insurance funds, and corporates.

European repo market maturity analysis (June 2019)^6

^6 ICMA ERCC European Repo Market Survey, No.37, November 2019