

June 29, 2018

Mr. Bobby Bean  
Associate Director  
Federal Deposit Insurance Corporation  
550 17th Street, N.W.  
Washington, D.C. 20429

Mr. Michael Gibson  
Director  
Board of Governors of the Federal Reserve System  
Eccles Board Building  
20th and C Street, N.W.  
Washington, D.C. 20219

Mr. Amrit Sekhon  
Deputy Comptroller for Capital and Regulatory Policy  
Office of the Comptroller of the Currency  
400 7th Street, S.W.  
Washington, D.C. 20219

**Re: Basel IV adoption and the treatment of securities financing transactions**

Dear Mr. Bean, Mr. Gibson, and Mr. Sekhon:

The American Bankers Association (ABA)<sup>1</sup> has submitted numerous letters to the U.S. banking agencies discussing Basel IV and making recommendations for practical, U.S.-tailored and objective-focused ways those standards can be adopted in the United States. This letter addresses the specific issue of the minimum haircut floors for Securities Financing Transactions (SFTs), about which we have not previously commented.<sup>2</sup>

We believe that the U.S. banking agencies should not at this time adopt minimum haircut floors for SFTs in any Basel IV implementation proposal in the United States, because certain aspects of the framework are overly broad and go beyond the stated objective “to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage.”<sup>3</sup> Moreover, we believe that the capital impact of the minimum haircut floors for SFTs

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<sup>1</sup> The American Bankers Association is the voice of the nation’s \$17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits, and extend nearly \$10 trillion in loans.

<sup>2</sup> ABA is in favor of the prompt adoption of other aspects of the revised methodology for SFTs as outlined in the letter from ABA to the banking agencies dated March 11, 2016, available at:

<https://www.aba.com/Advocacy/commentletters/Documents/FinalLetterToUSRegulatorsonBaselProposal.pdf>.

<sup>3</sup> FSB paper “Transforming Shadow Banking into Resilient Market-based Finance,” November 2015, See page 5, Available at: [http://www.fsb.org/wp-content/uploads/SFT\\_haircuts\\_framework.pdf](http://www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf).

is greater than necessary to achieve the stated policy objectives. Although the Financial Stability Board (FSB) conducted an impact study concluding that there would be a small impact,<sup>4</sup> the inclusion of minimum haircut floors for SFTs in Basel IV was not tested through the regular Quantitative Impact Study (QIS) data collection by the Basel Committee on Banking Supervision (BCBS). Therefore, we do not believe the FSB study fully represents the impact, which banks believe could be material in certain respects. We encourage the U.S. banking agencies to request that the BCBS revisit the minimum haircut floors to cure the deficiencies. Any new standard for minimum haircuts for SFTs should be evaluated through a QIS before it is made part of international standards or adopted in the United States.

## **I. The minimum haircut floors for SFTs are overly punitive and inappropriately applied**

On December 7, 2017, the BCBS released the final Basel IV framework. Paragraphs 180 to 188 of the framework specify the capital treatment of certain non-centrally cleared SFTs with certain counterparties. Those specify the use of minimum haircut floors for SFTs intended to address systemic risks resulting from banks' provision of short-term funding to unregulated counterparties. These minimum haircut floors apply to certain transactions, including secured lending<sup>5</sup> transactions and "collateral upgrade"<sup>6</sup> transactions.

The treatment of SFTs is punitive in its application, specifically,

- It includes transactions with regulated entities;
- It includes transactions where the primary intent is not to provide financing; and
- It does not recognize collateral provided for in-scope transactions that do not meet the minimum requirements.

These imprecisions in the treatment of SFTs result in a significant, unfounded, increase in risk-weighted assets for specific institutions and specific transaction types.

This outcome is inconsistent with the FSB's objectives as articulated in the 2014 report on strengthening the oversight and regulation of shadow banking. We further note that a number of post-crisis rules already address risks posed by SFTs within the banking sector, including the supplementary leverage ratio, G-SIB capital buffer, stress testing, and the liquidity coverage ratio, among others. These changes in regulation have made intermediation more costly through higher regulatory capital requirements, prompting banks to be less willing to undertake repo market intermediation compared with the pre-crisis period.<sup>7</sup> Application of minimum haircut floors for SFTs in the Basel IV framework could have further unintended detrimental impacts on the repo and securities lending markets.

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<sup>4</sup> FSB paper "Strengthening Oversight and Regulation of Shadow Banking" October 2014, see page 20, Available at [http://www.fsb.org/wp-content/uploads/r\\_141013a.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_141013a.pdf?page_moved=1).

<sup>5</sup> Reverse repurchase transactions, securities borrowing, and margin lending transactions against non-government securities collateral with counterparties that are not supervised by a regulator that imposes prudential requirements consistent with international norms. Lending of cash transactions where 1) the counterparty attests to reinvest the cash at the same or shorter maturity than the security lent, or 2) the counterparty attests to reinvest cash in a fund or account subject to regulations, are not within the scope of the SFT haircut floor treatment.

<sup>6</sup> Where "a bank lends a security to a counterparty and the counterparty pledges a lower quality security as collateral" Paragraph 180 of Basel IV.

<sup>7</sup> <https://www.bis.org/publ/cgfs59.htm>.

We encourage the U.S. banking agencies to revisit the issue with the BCBS and make the changes described in Section II. In the meantime, we do not believe minimum haircut floors for SFTs should be adopted in the United States.

## **II. Mitigate negative unintended consequences of the haircut floor for SFT transactions**

The following adjustments to the minimum haircut floors for SFTs in Basel IV would better focus the provisions on the objectives sought.

*Narrow the range of in-scope counterparties by excluding regulated entities, such as broker-dealers, 1940 Act Mutual Funds, ERISA Pension Funds, and their foreign equivalents*

The minimum haircut floors for SFTs are intended to target systemic risks resulting from the build-up of excess leverage outside the regulated sector. Therefore they exclude transactions by banks with certain regulated entities, such as other banks and central counterparties. However, many regulated entities that cannot contribute to the build-up of excess leverage outside the regulated sector are included as counterparties subject to the minimum haircut floors for SFTs, such as SEC-regulated broker-dealers, SEC-regulated mutual funds, and ERISA pension funds.

While mutual funds registered under the Investment Company Act of 1940 (1940 Act Funds) are not subject to the same prudential regulations as banks, they are still highly regulated entities. 1940 Act funds must disclose quarterly and are limited in the amount of leverage they use. Such leverage limits mean that mutual funds are unlikely to contribute materially to the build-up of excess leverage, and the requirement to disclose makes it unlikely that any build-up of leverage can be hidden from the regulators who receive the disclosures. In addition to limits and disclosure requirements for leverage, mutual funds must also abide by a number of other regulations, including liquidity management, redemption requirements, and external oversight. Similar regulatory requirements exist for Undertakings for Collective Investments in Transferable Securities, the international equivalent of a 1940 Act Fund.

*Exclude securities borrowing transactions from the scope of SFTs subject to the minimum haircut floors*

The FSB has recognized that not all SFTs are transactions with the intent to provide or receive financing. Specifically, the FSB noted that “securities borrowing can be excluded if the borrower of the securities intends to use the received securities to meet a current or anticipated demand (e.g. delivery obligations, customer demand, segregation requirements).”<sup>8</sup> Therefore, the FSB specifically proposed to exclude securities borrowing transactions from the minimum haircut floors if the intent of the transaction is not to provide financing but is instead to meet current or anticipated demand for securities. While Basel IV does exclude certain transactions where the intent is not to provide financing, they do not go far enough.

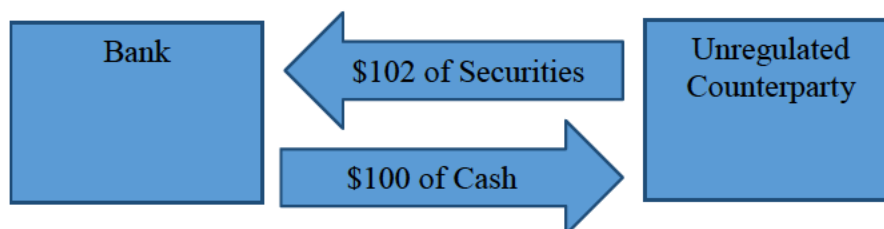
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<sup>8</sup> “Regulatory framework for haircuts on non-centrally cleared securities financing transactions” <http://www.fsb.org/2015/11/regulatory-framework-for-haircuts-on-non-centrally-cleared-securities-financing-transactions-2/>.

In a transaction where the bank intends to use the received securities to meet client demand, the bank will *provide* over-collateralization because the bank needs the security. The bank is therefore under-collateralized and will fail to meet the minimum haircuts. In fact, rule 15c-3-3 under the Securities Exchange Act of 1934 requires a broker-dealer to collateralize borrowing from the customer to a *minimum* of 100%. This is in contrast to a transaction where the intent is to provide financing. In these instances, the bank will *receive* over-collateralization because the counterparty needs the cash to fund its activities. The examples below illustrate this very idea.

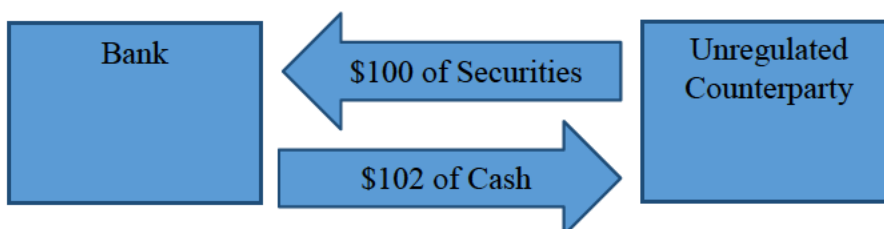
In this first example, the counterparty will initiate the transaction in order to obtain financing to fund its business activities. To obtain that financing, the bank enters into a reverse repo and requires the cash to be over-collateralized.

Example of a reverse repo funding transaction



However, in a securities borrowing transaction, the primary purpose is to make the security available to a bank's client. As a result, the cash lent is not for funding purposes but is merely collateral so the bank can gain access to the security. In these transactions, the bank will initiate the transaction and will generally provide over-collateralization to access the security.

Example of a securities borrowing client demand transaction



*Allow exemptions via supervisory review process*

The simplistic nature of the formulas for the minimum haircuts for SFTs might cause netting sets of SFTs or individual trades to fail to meet the minimums even if the transactions were prudently underwritten. A particular example of this is with cross-product netting agreements across derivatives and financing transactions. ABA recommends permitting supervisors to establish a process to allow them to grant exemptions from the minimum haircuts for SFTs for certain trades or netting sets of SFTs that do not meet the minimum haircuts if the bank can demonstrate that credit risk has been appropriately mitigated.

### *Recognize collateral*

Transactions that do not meet the minimum haircut floors for SFTs are treated as unsecured loan exposures, even if the transaction is collateralized. Thus, banks must hold capital in excess of the risk presented by SFTs that do not meet the minimum haircut floors. ABA recommends that the U.S. banking agencies encourage the BCBS to recognize collateral for these exposures—at least partially—in order to align capital charges better with risk. For example, the BCBS could consider adopting option 2 set forth by the FSB<sup>9</sup> and scaling capital requirements for transactions below the floors in proportion to the size of the collateral shortfall.

### *Ensure appropriate calibration of any new standard through a QIS*

The BCBS has maintained that Basel IV will not lead to significant increases in capital requirements. Moreover, in 2014 the FSB stated the belief that the impact of the haircut floors was “generally small.”<sup>10</sup> The examples we describe above demonstrate that neither is the case. We believe that the impact may be unmeasured and the operation of the minimum haircut floor for SFTs inappropriate, because it was never included in a QIS data collection. As a result, we urge the U.S. banking agencies to encourage the BCBS to revise the minimum haircut for SFTs as described above and include the new refined standard as part of a QIS data collection.

## **III. Conclusion**

In the current form, the minimum haircut floors for SFTs should not be part of U.S. regulatory capital rules. Certain aspects of the framework are overly broad and go beyond the stated intent “to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage.”<sup>11</sup> We encourage the U.S. Agencies to use their representation at the BCBS to revisit the issue internationally to: 1) Narrow the scope of SFTs subject to the haircut floor; 2) Incorporate flexibility for specific exemptions through a supervisory review process; 3) Recognize collateral for transactions below the haircut floors; and 4) Include any revised standard in a QIS to ensure appropriate calibration.

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<sup>9</sup> FSB paper titled “Strengthening Oversight and Regulation of Shadow Banking,” October 14, 2014, See page 14-15, available at: [http://www.fsb.org/wp-content/uploads/r\\_141013a.pdf](http://www.fsb.org/wp-content/uploads/r_141013a.pdf).

<sup>10</sup> *Id.* page 20.

<sup>11</sup> FSB paper “Transforming Shadow Banking into Resilient Market-based Finance,” November 2015, See page 5, Available at: [http://www.fsb.org/wp-content/uploads/SFT\\_haircuts\\_framework.pdf](http://www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf).

If you have any questions about the content of or issues addressed in this letter please contact the undersigned, Hugh Carney, at (202) 663-5324.

Sincerely,

A handwritten signature in black ink, reading "Hugh C. Carney". The signature is fluid and cursive, with the first name "Hugh" being the most prominent.

Hugh C. Carney  
Vice President of Capital Policy  
American Bankers Association