Risk Management Association

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SECURITIES LENDING COUNCIL

January 16, 2024

Via Electronic Submission

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Docket No. R—1813; RIN 7100—AG64

James P. Sheesley, Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064–AF29)
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429
RIN: 3064—AF29

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency (OCC)
400 7th Street, SW
Suite 3E-218
Washington, D.C. 20219
Docket ID OCC—2023—0008

Re: Comment Letter on the Agencies' Proposal to Modify the Capital Requirements Applicable to Large Banking Organizations

Dear Sir or Madam:

The Securities Lending Council (the "RMA Council") of the Risk Management Association (the "RMA")[1] appreciates the opportunity to submit this letter to the Board of Governors of

[1] The RMA Council 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.

the Federal Reserve System (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC," and collectively with the FRB and the FDIC, the "Agencies") on behalf of the RMA Council's numerous members that participate in the industry as securities lending agents ("Lending Agents"), including some of the largest U.S. custody banks and asset managers. This letter addresses the Agencies' proposed revisions to capital requirements for large banking organizations and banking organizations with significant trading activity (the "Proposal"),[2] which implements the Basel Committee on Banking Supervision's ("BCBS") 2017 revisions to the Basel III framework (the "Basel Framework").

While we appreciate the improvements in risk-sensitivity in certain areas and offer targeted suggestions to improve the overall calibration of the Proposal, we stress that our ability to adequately evaluate and provide feedback was hindered by a lack of data and analysis, especially with respect to the Proposal's divergences from the Basel Framework and how it has been proposed to be implemented in other jurisdictions. In order to develop a more data-driven proposal, and to provide the RMA Council with the opportunity to properly respond to the processes by which the Proposal was developed, we would join other trade groups in requesting a re-proposal of the rule.[3] While we understand the Agencies' preference to implement the Basel Framework within a specific timeline, we do not believe this concern should override the Agencies' overall aim to implement a targeted, risk-sensitive and data-based proposal.

Although the Agencies extended the deadline to comment on the Proposal, the FRB also launched its data collection to assess the impact of the Proposal on affected institutions with a deadline coinciding with the deadline for this comment letter. We appreciate that the Agencies will have this data when evaluating the next steps in the rulemaking process, but we think it is also imperative that affected institutions have an opportunity to analyze the collected data and respond to the conclusions that the Agencies draw from that data. As such, we request that the rule be re-proposed, taking into account the comments received and the data collected.

In any case, this comment letter is based on the current version of the Proposal.

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[2] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023).

[3] *See* American Council of Life Insurers, et al., "U.S. Chamber Coalition Letter on New Bank Capital Standards," (Nov. 14, 2023), *available at* https://www.uschamber.com/assets/documents/20231113-US-Chamber-Coalition-Letter-on-Basel-III-Federal-Reserve.pdf; *see also* Bank Policy Institute, et al., "Quantitative Impact Study of the Potential Effects of Proposed Regulatory Capital Rules" (Oct. 13, 2023), *available at* https://www.federalreserve.gov/SECRS/2023/November/20231101/R-1813/R-1813_101323_154734_486154207979_1.pdf.

Executive Summary

The Proposal is not sufficiently risk-sensitive – some proposed requirements are overly broad and/or not properly calibrated to the risk of the assets to which they apply. To address these concerns, in no particular order, the following clarifications and changes should be made:

- The final rule should permit banking organizations to assign a risk weight of 65% to exposures to investment grade registered investment companies ("RICs").
- The final rule should permit banking organizations to assign a risk weight of 65% to exposures to investment grade Pension Funds (defined below).
- The final rule should adopt a more risk-sensitive approach for exposures to highly capitalized banking organizations.
- The final rule should adopt the Basel Framework's approach to short-term bank exposures.
- The final rule should broaden the scope of exposures subject to the "bank" framework to include financial institutions prudentially regulated as banks, including consolidated subsidiaries of a bank holding company ("BHC").
- The final rule should amend the definition of "financial collateral" to include debt securities issued by sovereigns or public sector entities ("PSEs") treated as sovereigns, regardless of investment grade status.
- The final rule should eliminate the public listing requirement to recognize the risk-mitigating effects of a corporate debt security.
- The final rule should not implement minimum haircuts for securities financing transactions ("SFTs").
- The final rule should permit banking organizations to elect to apply the revised collateral haircut approach ("CHA") in lieu of the current CHA for standardized approach purposes.
- The final rule should amend the CHA to provide that, at the banking organization's option, haircuts for Exchange Traded Funds ("ETFs") will be determined based on their underlying holdings, not at the ETF level.
- The final rule should disregard 0%-risk-weight sovereign securities when determining the largest E_S in the calculation of "N" in the revised CHA formula.
- The Agencies should clarify, or the final rule should provide that, exposures to an index of securities, including ETFs, should be treated as an exposure to the underlying securities, not the index as a whole, for the purposes of calculating the "N" parameter.

- The Agencies should clarify or the final rule should provide that where a repo-style transaction can be settled through the delivery of the applicable security or by cash in lieu of securities, the "settlement currency" is the currency in which the security or required cash is denominated and not the cash settlement currency identified in the relevant master securities lending agreement.

- The final rule should establish a transition period to phase out internal models-based approaches for purposes of the SCCL, permitting firms, on an optional and transitional basis, to recognize the difference between the modelled approach and the revised CHA.

- U.S. Treasury securities should continue to be exempt from the minimum haircuts.

- The services component of the business indicator should be reduced by capping the fee and commission income component to a set percentage of an institution-specific factor that takes into account other areas where operational risk contributes to capital requirements.

- In the calculation of operational risk, the internal loss multiplier ("ILM") should be set at 1.

- The final rule should exempt commercial end-users from credit valuation adjustment ("CVA") requirements.

- Alternatively, the treatment of central clearing should be modified to increase risk sensitivity.

- Only the cash leg of term repo-style transactions should be considered under market risk.

- Sector buckets under the sensitivities-based method should distinguish between safer financial institutions, such as RICs and Pension Funds, and riskier nonbank financial institutions.

- The net default exposure methodology for non-securitization debt or equity positions should permit treating rolling equity hedges as if they match the maturity of the positions they are hedging.

- Banking organizations should be permitted to assume a margin period of risk ("MPoR") of 4+N for all derivative transactions.

- Proper hedges of non-modellable risk factors should be recognized in calculating RWAs.

- The Agencies should clarify that sovereign wealth funds are PSEs under the final rules.

In the next section, we offer some background and general observations, and in the section that follows, we discuss the recommendations outlined above in greater detail.

I. Background and General Considerations

A. Agency Securities Lending

Agency securities lending is a well-established, safe and sound activity that supports global capital markets activities and facilitates trade settlement. By effectively increasing the supply of securities available for these and other market activities, securities lending improves market liquidity and enhances price discovery.[4] Securities lenders largely consist of buy-side entities, such as public and private pension funds, mutual funds, Employee Retirement Income Security Act ("ERISA") plans, endowment funds of not-for-profit institutions, insurance companies, investment funds and other similar entities or funds into which such entities invest. Borrowers in securities lending transactions largely consist of broker-dealers, banks and other financial institutions.

Lending Agents act as intermediaries in securities lending programs by facilitating loans on behalf of beneficial owners to qualified borrowers. Securities are generally lent pursuant to a (i) securities lending authorization agreement between the beneficial owners and the Lending Agents, and (ii) securities borrowing agreement between the borrower and the Lending Agents (acting in an agency capacity on behalf of the beneficial owners as principal). Under these agreements, the borrower provides initial collateral to the beneficial owners (generally, via its Lending Agent) in excess of the value of the loaned securities, usually by 2% to 5% depending upon the characteristics of the loaned securities and the collateral. The loaned securities and collateral are then marked-to-market daily to ensure that the collateral consistently meets the requisite value. The margins for securities lending transactions are typically low. Because agency lending typically involves a Lending Agent guaranty against borrower credit risk, agency lending by capital-regulated banks is also somewhat capital intensive. Accordingly, securities lending generally requires economies of scale to be profitable, and even marginal increases in cost may drive supply-side liquidity out of the market unless it can be offset with increased fees.[5]

As of year-end 2022, RMA composite data, compiled from the responses of 13 member institutions, showed approximately $26 trillion of loaned securities globally, consisting of $20 trillion of U.S. lendable assets and $6 trillion of non-U.S. lendable assets in the securities lending market. Of those

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[4] Beneficial owners use agency securities lending services from Lending Agents in order to obtain additional incremental revenues. Agency securities lending activities developed initially as an outgrowth of Lending Agents' custody and related activities, and have long been regulated, examined and treated by regulators as traditional banking services. *See, e.g.*, OCC, "Banking Issuance," BC-196 (May 7, 1985), *available at* https://www.occ.gov/static/news-issuances/bulletins/pre-1994/banking-circulars/bc-1985-196.pdf ("The policy is directed toward national banks that are lending securities from their own investment or trading accounts or from safekeeping, trust or pension accounts of their customers"); Letter from J. Virgil Mattingly, General Counsel, FRB, William F. Kroener, General Counsel, FDIC, and Julie L. Williams, General Counsel, OCC, "Re: File No. S7-41-02-Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 ('Proposed Rules')" (Dec. 10, 2002), *available at* https://www.sec.gov/rules/proposed/s74102/jvmattingly1.htm (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"); Council Directive 2004/39/EC, 2004 O.J. (L 145/1), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF.

[5] As discussed in more detail in Section I.C, market contraction is more likely than increased fees because of the already low margins involved in the industry.

assets, over $672 billion of U.S. securities and $117 billion of non-U.S. securities were on loan against cash collateral.

B. Borrower Default Indemnification

As a matter of standard market practice developed over the past several decades, Lending Agents 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 Lending Agents' risk management systems. Moreover, many lending clients (e.g., U.S. clients subject to ERISA) are required under U.S. law to receive borrower default indemnification by a Lending Agent 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 ETFs and other Retail Undertakings for the Collective Investment in Transferable Securities ("UCITS") funds that loan securities.[8]

C. Impact of Proposal on Capital Markets

Many of the largest banking organizations in the world (who would be subject to the Proposal) engage, as Lending Agents, in securities lending activities, a function that is critical to the global markets. While certain aspects of the Proposal would represent significant and meaningful improvements to existing practices, particularly with respect to quantifying exposures for "repo-

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[6] *See* Prohibited Transaction Exemption (PTE) 2006-16, Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63786 (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 § 815.303(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 at 4 (Oct. 2023), *available at* https://www nystrs.org/NYSTRS/media/PDF/IPM.pdf (requiring that the agent lender indemnify the System for losses resulting from a default by the borrower); New Jersey Department of the Treasury, Department of Investment, "Request for Proposals for Securities Lending Services" at 6-7, *available at* https://www.nj.gov/treasury/doinvest/pdf/Rfp/SecLendingFinal.pdf ("For securities lending services the Contractor shall satisfy and maintain the following minimum qualifications and requirements for the duration of the contract… Be willing to accept responsibility for DOI's securities lending program on an agency basis as a fully indemnified program specific to operational risk and borrower default").

[8] *See* ESMA, "Consultation paper: ESMA's guidelines on ETFs and other UCITS issues," ESMA/2012/44 at 42, 68 and 75 (Jan. 30, 2012), *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-44_0.pdf.

style transactions"[9] and "eligible margin loans," we have concerns about certain other aspects of the Proposal, including its overall calibration and the potential impacts it may have on the capital markets.

Notwithstanding the improvements in the Proposal compared to the current standardized approaches, if the Agencies finalize the rule as currently proposed, the result could be compression of securities lending and related services 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 and related services would further reduce returns to government plans and other lending clients. $800 billion of on-loan balances, or 88% of all securities lending activity from U.S. Lenders, will likely become unprofitable to sustain, resulting in a significant liquidity drain from the capital markets.[10] Regulatory capital is a key driver in whether such transactions are profitable and operates as a binding constraint on the market. Increased costs thus are more likely to force lenders of such securities out of business, contracting the market.[11] 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 swaps collateral[12] and other regulatory mandates. The combined effect of such events could destabilize capital markets at the very time market liquidity has become increasingly important as markets increase in breadth and complexity.

In addition, we urge the Agencies to consider carefully how the Proposal would interact with other elements of their prudential regulatory framework, including, among others, stress testing, resolution planning and activities limitations. These reforms already represent a significant and fundamental shift in the regulation of agency securities lending transactions, and care must be taken to avoid a cumulative negative impact on capital markets.

Below, we offer our specific comments on the Proposal, organized by broad topic area.

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9 The Proposal would retain the current definition of "repo-style transaction" under capital regulations, which refers to "a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the Board-regulated institution acts as agent for a customer and indemnifies the customer against loss," provided certain conditions are met. 12 CFR § 217.2.

10 EquiLend Data & Analytics (Dec. 18, 2023) (data received to RMA directly indicated GC loans represent 88% of the total number of securities on loan by U.S. lenders as of December 18, 2023). "General collateral" securities lending is, by definition, a low margin, high-volume business. Reporting of Securities Loans, 88 Fed. Reg. 75644, 75708 (Nov. 3, 2023) ("general collateral securities lending is a low margin business and lending supply for these securities far outstrips lending demand.").

11 88 Fed. Reg. at 75708 ("Combined, these two factors mean that there is likely not much room for fees to improve for general collateral securities.").

12 As noted, increased costs on lenders would likely reduce supply instead of increasing fees.

II. Recommendations for Credit Risk

A. The final rule should permit banking organizations to assign a risk weight of 65% to exposures to investment grade RICs.

Under the Proposal, a banking organization may assign a 65% risk weight to a debt exposure to a company so long as: (1) the company is "investment grade"[13] and (2) the company is, or is controlled by, a company that has publicly-traded securities outstanding (the latter, the "Public Listing Requirement"). Although we believe that the Public Listing Requirement is not appropriate for corporate exposures more generally, we believe that it is particularly inappropriate for highly-regulated entities that do not have publicly-traded securities outstanding (as a matter of business practice), or do not have access to, public securities markets but that are subject to comparable levels of disclosure. Allowing such entities to benefit from a 65% risk weight (provided that they are "investment grade") would be fully consistent with the Agencies' objectives in proposing the Public Listing Requirement while recognizing the risk-mitigating benefits of the statutory safeguards to which these entities are subject. Absent this, highly-regulated entities would bear greater lending costs or reduced lending opportunities.

In particular, as suggested by Question 39, we recommend that exposures to entities satisfying the definition of "registered investment companies and excluded entities" under the Volcker Rule or foreign equivalents thereof should not be subject to the Public Listing Requirement.[14] Alternatively, we recommend that the Public Listing Requirement be modified to include entities subject to equivalent or more stringent financial reporting standards, such as those to which RICs would be subject.

The Agencies justify the Public Listing Requirement by stating that it would provide consistency between organizations and because public companies are subject to enhanced transparency and market discipline. With regard to consistency, RICs are subject to stringent statutory and regulatory disclosure requirements. For example, RICs are required to register with a securities regulator and are subject to a statutory and regulatory regime that defines how they are structured, how they can invest and how they must operate. This includes custody requirements, restrictions on affiliate transactions and leverage requirements. As an added layer of protection, RICs are generally

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[13] The Proposal would retain the current definition of "investment grade" under capital regulations: "the entity to which the Board-regulated institution is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the asset or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected." 12 CFR § 217.2.

[14] 12 CFR § 248.10(c)(12) ("An issuer: (i) That is registered as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), or that is formed and operated pursuant to a written plan to become a registered investment company as described in § 248.20(e)(3) of subpart D and that complies with the requirements of section 18 of the Investment Company Act of 1940 (15 U.S.C. 80a–18); (ii) That may rely on an exclusion or exemption from the definition of 'investment company' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act; or (iii) That has elected to be regulated as a business development company pursuant to section 54(a) of that Act (15 U.S.C. 80a–53) and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company as described in § 248.20(e)(3) of subpart D and that complies with the requirements of section 61 of the Investment Company Act of 1940 (15 U.S.C. 80a–60).").

managed by fund managers that are themselves subject to regulatory oversight, including an obligation to act in investors' best interest and to manage the fund in accordance with any applicable investment mandate.

With regard to enhanced transparency and market discipline, RICs are subject to extensive disclosure and supervisions regimes, in line with or beyond those of public companies, including annual and yearly reports to the U.S. Securities and Exchange Commission ("SEC").[15] In particular, RICs must meet detailed transparency, asset valuation and investor disclosure requirements, including the issuance of fund prospectuses, regular reporting of audited and unaudited financial statements and the daily calculation of net asset values.

Further, unlike public companies, which are mainly regulated based on the accuracy of their disclosures (as opposed to the conduct disclosed), RICs are subject to regulations concerning their structures, policies and procedures, including specific leverage and liability requirements and detailed asset quality, coverage and diversification mandates.[16] These additional layers of prudential regulation and oversight reduce their credit risk compared to public companies.

Finally, while certain categories of RICs, such as ETFs, are listed on an exchange, primarily as a means of providing investors with access to pools of assets on an intra-day basis, RICs do not issue debt or raise equity as a function of their structure and therefore have no objective reason to seek a listing.

The disparate treatment between RICs and public companies is therefore a function of the definitions and standards used in the Proposal and does not reflect an objective assessment of the structure, credit risk profile or credit loss history of RICs. Failing to implement our recommendations would artificially and disproportionately penalize RICs and, by extension, their underlying investors.

Recommendation

We recommend the Agencies assign a 65% risk weight to exposures to investment grade RICs.

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[15] 17 CFR § 270.30a-1; 17 CFR § 274.150. While not a strict requirement, RICs also typically disclose information through third-party vendors.

[16] Regarding leverage, RICs are not permitted to incur indebtedness that exceeds 33% of their assets. Similarly, UCITS are prohibited from borrowing more than 10% of the value of their assets; borrowing by other types of UCITS generally does not exceed 25% to 40% of their assets.

Regarding liquidity, U.S. mutual funds (a type of RIC) cannot invest more than 15% of their net asset value in illiquid assets, with illiquid assets defined as investments that cannot be sold within seven calendar days without significantly changing the market value of the investment.

Regarding diversification, open-ended mutual funds must generally limit their exposure to any single issuer to no more than 5% of their net asset value, and also cannot own more than 10% of the outstanding securities of any one issuer.

B. The final rule should permit banking organizations to assign a risk weight of 65% to exposures to investment grade Pension Funds.

Similar to our recommendation regarding RICs, we also recommend that exposures to a pension fund that is subject to a financial statement disclosure regime comparable to those of RICs be exempt from the Public Listing Requirement. For these purposes, "Pension Fund" means any federally regulated "plan, fund, or program providing pension, retirement, or similar benefits that is… [a] broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered."[17] Many Pension Funds cannot register securities, so the Public Listing Requirement would preclude safe Pension Funds from receiving their beneficial and deserved risk weight. Forcing trade counterparties to apply a higher risk weight to Pension Funds thus unfairly imposes additional costs on beneficiaries without any corresponding benefit to risk capture. We respectfully submit that the Agencies could accomplish their objectives of consistency, transparency and market discipline with respect to Pension Funds without a Public Listing Requirement.

As with RICs, Pension Funds (i) are subject to stringent statutory and regulatory disclosure requirements and extensive disclosure and supervision regimes, in line with or beyond those of public companies and (ii) are subject to regulations concerning their structures, policies and procedures rather than solely the accuracy of their disclosures.

Through requirements such as daily net asset value calculation requirements and disclosure requirements under the laws of several jurisdictions, Pension Funds often disclose information comparable to or, in some cases, greater than publicly listed entities. For example, many U.S. pension plans' financial statements must be subject to standards set by the Governmental Accounting Standards Board and are subject to audit by the Legislative Audit Bureau. State pension plans generally are also subject to open meeting laws, requirements concerning access to public records and oversight by elected bodies (e.g., state legislatures) and appointed boards. Regulated Pension Funds also typically report key performance metrics, such as funded status, returns on investments, plan liabilities, risk management and plan governance. Audited financial statements of Pension Funds typically are publicly available and comparable to the public disclosure made by widely-held corporations.

Moreover, Pension Funds are subject to prudential regulation by national (or state and provincial) agencies that govern the administration of the pension plans. In this regard, Pension Funds also typically use prudent investment strategies designed to maximize value for beneficiaries, so Pension Funds are often better credit risks than those that would qualify for the 65% risk weight under the Proposal.

Recommendation

[17] This definition is taken from the Volcker Rule's definition of "foreign pension or retirement funds." 12 CFR § 248.10(c)(5). Because this definition is meant to cover domestic and foreign pension funds, we exclude the pieces of that definition requiring the fund be outside of the United States or for the benefit of citizens and residents of foreign sovereigns or political subdivisions. Alternatively, as recommended with regard to RICs, we recommend that the Public Listing Requirement be modified to include entities subject to equivalent or more stringent financial reporting standards, such as those to which many Pension Funds would be subject.

We recommend the Agencies assign a 65% risk weight to exposures to investment grade Pension Funds equivalent to the risk weight assigned to companies that meet the Public Listing Requirement.

C. The final rule should adopt a more risk-sensitive approach for exposures to highly capitalized banking organizations.

The 2017 revisions to the Basel Framework provide, for banks that are subject to appropriate prudential standards and supervision, baseline risk weights of 40% for Grade A bank exposures, 75% for Grade B bank exposures and 150% for Grade C bank exposures under the Standardized Credit Risk Assessment Approach.[18] The Basel Framework and international proposals to implement the Basel Framework also provide for a 30% base risk weight for exposures to Grade A banks with a common equity tier 1 ("CET1") ratio of 14% or more and a Tier 1 leverage ratio of 5% or more, but the Proposal would not implement this.[19]

Grade A banks with high capital and leverage ratios are safer entities because such ratios provide a greater cushion in times of stress. By failing to include a 30% risk weight for such Grade A bank exposures, the Proposal fails to be appropriately risk-sensitive and deviates from internationally agreed standards.

Moreover, this departure would put U.S. Lending Agents at a disadvantage relative to international competitors, particularly outside of the United States, where borrowers tend to be banks (rather than securities firms). Non-U.S. Lending Agents in jurisdictions that have implemented the Basel Framework would be able to assign risk weights as low as 20% to banks rated AAA to AAA- and 30% to banks rated A+ to A-, while U.S. Lending Agents would only be able to assign risk weights of 40% for Grade A bank exposures. Because many large banking institutions are rated A- or better, foreign banks would have to hold as little as half the capital U.S. banks would have to hold against these exposures.

Recommendation

We recommend that, consistent with the Basel Framework and its international implementation, the final rule should adopt the 30% risk weight for Grade A banks with CET1 ratios at or above 14% and leverage ratios at or above 5%.

D. The final rule should adopt the Basel Framework's approach to short-term bank exposures.

The Proposal's treatment of short-term bank exposures may impede liquidity in the securities markets and monetary policy transmission.[20] For short-term bank exposures, which the Basel Framework defines as on- and off-balance sheet, "[e]xposures to banks with an original maturity of

[18] Basel Framework at CRE 20.21.

[19] *Id.* n. 15.

[20] This section is responsive to Question 19.

three months or less, as well as exposures to banks that arise from the movement of goods across national borders with an original maturity of six months or less," the Basel Framework provides lower risk weights for Grade A and B bank exposures, specifically: 20% for Grade A bank exposures and 50% for Grade B bank exposures. Short-term Grade C bank exposures are assigned the base 150% risk weight.[21] For countries that permit the use of external ratings, short-term exposures to banks graded BBB- and up receive a 20% risk weight, and exposures to banks graded B- and up receive a 50% risk weight.[22]

Instead of implementing the Basel Framework's approach to short-term bank exposures, the Proposal would limit the favorable 20% and 50% risk weights to a foreign Grade A or B bank exposure that "is a self-liquidating, trade-related contingent item that arises from the movement of goods and that has a maturity of three months or less."[23]

Among other reasons, a stated purpose of the lower risk weights for short-term bank exposures "is to avoid interference with monetary policy channels and to prevent any negative impact on market liquidity in interbank markets."[24] As described above, a significant portion of the securities lending market, particularly outside of the United States, is interbank. The Proposal does not address the rationale for limiting the short-term bank exposure framework in this manner and does not address the potentially significant negative consequences on market liquidity in interbank markets or on monetary policy transmission that would result from the difference between the Proposal and the Basel Framework and international implementations (proposed and final) of the Basel Framework.

Recommendation

We recommend that consistent with the Basel Framework and its international implementation, the final rule should at the very least adopt the Basel Framework's approach to the scope of short-term bank exposures eligible for lower risk weights.

E. The final rule should broaden the scope of exposures subject to the "bank" framework to include financial institutions prudentially regulated as banks, including consolidated subsidiaries of a BHC.

The Basel Framework for bank exposures extends to securities firms and other financial institutions subject to prudential standards and supervision equivalent to banks.[25] Consistent with the Basel

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21 *Id.* at CRE 20.19; 20.21.

22 *Id.* at CRE 20.18.

23 Proposal at 64041.

24 BCBS, "Revisions to the Standardized Approach for credit risk," Second Consultative Document at 6 (Dec. 10, 2015), *available at* https://www.bis.org/bcbs/publ/d347.pdf.

25 Basel Framework at CRE 20.16 ("For the purposes of calculating capital requirements, a bank exposure is defined as a claim (including loans and senior debt instruments, unless considered as subordinated debt for the purposes of CRE 20.60) on any financial institution that is licensed to take deposits from the public and is subject to appropriate prudential standards and level of supervision.").

Framework, the EU and UK propose to apply risk weights for bank exposures to "institutions," which include both deposit-taking "credit institutions" and "investment firms," such as broker-dealers.[26]

The Proposal's definition of "bank exposure" is narrow: "an exposure to a depository institution, foreign bank, or credit union."[27] The Proposal justifies its treatment of bank exposures by appealing to the objectives of the rule –"simplicity, transparency, and consistency" – but does not address why the broader definitions from the Basel Framework or other jurisdictions would not help to further those goals.[28] As noted above, the Basel Framework allows banking organizations to assign risk weights for banks to securities firms that are subject to prudential and supervisory standards equivalent to banks in recognition of the fact that in many major jurisdictions, there is no bright line between commercial and investment banking as in the United States. This would include, for example, foreign broker-dealers subject to prudential requirements, a class of entities excluded from the Proposal's definition. The Proposal supports its treatment of "bank" exposures by stating that the rule would be "objective and transparent" by incorporating "publicly disclosed capital levels," but it is for this same reason that other prudentially regulated entities should be subject to the same treatment. In carrying forward this narrow definition under the Proposal, the Agencies project artificial U.S. statutory and regulatory distinctions onto the rest of the world in a manner inconsistent with broad international consensus. In so narrowing the definition, the Proposal would significantly limit Lending Agents' ability to competitively lend securities to non-U.S. borrowers, particularly in the EU and UK, where many borrowers are securities firms that are subject to bank prudential regulations.

Further, while not subject to prudential regulation directly, the rule would exclude consolidated subsidiaries of BHCs within the scope of those "prudentially regulated." This is particularly relevant to Lending Agents who commonly lend to U.S. broker-dealer subsidiaries of BHCs. As the BHC is prudentially regulated, any subsidiary of the BHC that is consolidated would be regulated by virtue of being a BHC subsidiary. Moreover, their capital would contribute to the BHC's overall capital requirement, and they would be subject to similar activity limits. Lending Agents' largest U.S. borrowers also tend to be broker-dealer subsidiaries of GSIBs, which all use a single point of entry resolution strategy and would remain operating concerns in default. Therefore, exposures to such broker-dealers would be safer exposures because they are BHC subsidiaries.

As such, exposures to consolidated subsidiaries deserve the same capital treatment as exposures to their parent BHCs.

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[26] European Banking Authority ("EBA") Capital Requirements Regulation ("CRR"), Article 121(1) (applying to "institutions"); EBA CRR, Article 4(3) ("'institution' means a credit institution or an investment firm").

[27] Proposal § __.101.

[28] *Id.* at 64041.

Recommendations

We recommend that consistent with the Basel Framework and its international implementation, the final rule should assign risk weights for bank exposures to financial institutions that are subject to the BCBS's capital and prudential standards, including consolidated subsidiaries of a BHC.

III. Recommendations for Credit Risk Mitigation (Generally)

A. The final rule should amend the definition of "financial collateral" to include debt securities issued by sovereigns or PSEs treated as sovereigns, regardless of investment grade status.

Under the current rule, the only debt securities considered "financial collateral" are investment grade securities and publicly traded convertible bonds.[29] Under the Proposal, the definition of financial collateral would be largely unchanged, but this diverges from the Basel Framework, which includes "[d]ebt securities issued by sovereigns or PSEs that are treated as sovereigns by the national supervisor"; provided that the bank's home supervisor is sufficiently confident that the market liquidity of the security is adequate.[30]

This divergence is inappropriate given the demonstrated liquidity of the sovereign debt market and would be inconsistent with the treatment of sovereign and PSE debt elsewhere in the Proposal. For example, sovereign exposures for sovereigns with a Country Risk Classification ("CRC") between 0 and 2 and for OECD members with no CRC are subject to preferential risk weights below 100%.[31] By their nature, sovereign and PSE exposures are creditworthy and liquid investments, so requiring each such security to be designated as investment grade in order to qualify as "financial collateral" is an unnecessary obstacle.

Recommendation

The definition of "financial collateral" should therefore be expanded to include debt securities issued by sovereigns or PSEs treated as sovereigns, regardless of investment grade status.

B. The final rule should eliminate the public listing requirement to recognize the risk-mitigating effects of a corporate debt security.

The Proposal would only permit a banking organization to recognize the risk-mitigating benefits of a corporate debt security if the issuer of the debt security has a publicly traded security outstanding or is controlled by a company that has a publicly traded security outstanding.[32] We recommend

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29 12 CFR § 217.2.

30 Basel Framework at CRE 22.34(4). The Agencies did propose a small change to the definition but this was a mere clarification and was in line with the way the rule currently operates in practice.

31 *See* Proposal at § __.111(a)(2); Proposal at § __.111(e).

32 *Id.* at § __.121(a)(3).

removing the public listing requirement from the criteria to qualify as financial collateral and, if desired, replacing it with more nuanced criteria based on the stated goals of the Proposal.

The Agencies do not explain why a public listing requirement would justify the significant and unnecessary costs it would impose on lending to creditworthy private companies or whether there are credible alternatives that accomplish the Agencies' objectives.

In the corporate exposures context, the Agencies argue that (i) the requirement is simple and objective, so it would provide consistency between organizations, and (ii) publicly-traded companies are subject to enhanced transparency and market discipline. Neither justification is persuasive.

Consistency. While a public listing requirement would provide some measure of consistency, the dimensions across which such consistency is manufactured only bear a tenuous relationship to creditworthiness.[33] Public listing standards are aimed at ensuring a baseline of information to retail investors, who might not otherwise know what information to request or how to request it, and in many cases do not bear a reasonable relation to how sophisticated banking organizations evaluate credit risks. There is no evidence or analysis to suggest that a public listing requirement would result in an increase in consistency across banking organizations' assessments of creditworthiness or that any statistical effect demonstrating such increase represents something meaningful, given that public listing requirements vary from exchange to exchange and across jurisdictions.

Market Discipline and Transparency. As to market discipline and transparency, there is no discernible reason why a banking organization would be more conservative in its credit assessment of a publicly listed company, except to the extent that the criteria for public listing overlap with the banking organization's internal criteria for due diligence, in which case the requirement would be redundant (as has been recognized by the UK).[34]

A public listing requirement would increase the cost to banking organizations to lend to private investment grade entities, including many high-quality corporate exposures like mutual funds and pension plans that do not typically list securities on an exchange and put U.S. banking organizations at a competitive disadvantage because the public listing requirement was rejected by both the European Union and the United Kingdom.

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[33] In fact, in the banking context, one study published in the FRBNY Economic Policy Review stated, "risk between publicly held and privately owned banking companies—whether measured by loan portfolio quality or earnings variability—is statistically indistinguishable." Simon H. Kwan, "Risk and Return of Publicly Held versus Privately Owned Banks," FRBNY Economic Policy Review (Sept. 2004), *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/04v10n2/0409kwan.pdf.

[34] Bank of England, "CP16/22 – Implementation of the Basel 3.1 standards," Consultation Paper 16/22 at 3.99 (Nov. 30, 2022), *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622-full.pdf ("A corporate entity would not need to have securities outstanding on a recognised exchange to be assessed as IG. However, firms would need to have sufficient information to conduct adequate due diligence for the assessment of whether the corporate entity is IG.") [hereinafter, "England Consultation Paper 16/22"].

Recommendation(s)

We recommend removing the public listing requirement from the criteria to qualify as financial collateral.

IV. Recommendations for the Revised CHA

A. The final rule should not implement minimum haircuts for SFTs.

Under the CHA, to recognize the risk mitigation benefit of financial collateral that secures an eligible margin loan or repo-style transaction with an unregulated financial institution or netting set of such transactions with an unregulated financial institution, the collateral haircut applicable to the transaction must be higher than the assigned haircut floor. Lending Agents participate in the SFT markets primarily as securities lenders. Although securities loans are SFTs (and "repo-style transactions" under the Proposal), these securities loans do not result in the type of shadow banking leverage that the haircuts are meant to mitigate. In particular, when Lending Agents receive cash collateral in exchange for lending securities, they do not access the market to borrow cash or finance securities positions. Rather, the cash is meant to serve as security for use by the borrower of the applicable security. Said differently, securities loans are securities-driven rather than cash-driven.

As described above, this intent is evidenced by standard market haircuts, which typically require the value of the collateral received to *exceed* the value of the securities lent. This overcollateralization, however, means that such transactions would mechanically fail any minimum haircut requirement from the perspective of the borrower or collateral provider (absent any relevant exception).

Both the Agencies and the SEC recognize the critical distinction between securities-driven and cash-driven transactions in the current regulatory framework. For example, the FRB's Regulation T exempts securities lending and borrowing transactions from minimum margin requirements to the extent the transaction is made for "the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations."[35] Regulation T further clarifies that the required deposit of cash against borrowed securities must be "bona fide."[36]

Similarly, the SEC's customer protection rule (15c3-3) generally mandates that broker-dealers that borrow securities must fully collateralize such borrowings (subject to daily mark-to-market and margining requirements).[37] Thus, absent a workable exception, the Proposal's minimum haircuts would conflict directly with banking organizations' obligations to appropriately collateralize their securities borrowings. The Agencies seem to acknowledge the challenge with applying the minimum haircut rule to entities with full collateralization requirements because the Proposal only requires exposures to "unregulated financial institutions" to comply with minimum haircut

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35 12 CFR § 220.10(a).

36 12 CFR § 220.103(e).

37 17 CFR § 240.15c3-3(b)(3)(iii).

requirements. The definition of "financial institution" excludes employee benefit plans under ERISA and RICs, two other entities whose regulators impose full collateralization requirements when engaging in securities lending and thus, would be adversely impacted if subject to the minimum haircuts framework.[38]

We recognize that the Proposal attempts to provide conceptually appropriate exemptions that would, in principle, exclude the types of SFTs in which our members engage. As drafted, however, we are concerned that these exemptions could create significant operational burdens for our members and banking organizations to comply with the exemptions that would make reliance on the exemptions impractical. Accordingly, it is imperative that these exemptions are implemented consistent with the underlying policy principles animating them and in a manner that would eliminate unnecessary burdens on market participants.

Minimum SFT haircuts were proposed nearly a decade ago by the Financial Stability Board ("FSB") to address risks related to shadow banking.[39] Lending Agents are not shadow banks, and securities lending by Lending Agents does not contribute to the build-up of leverage outside of the regulated financial sector. As the FSB has recognized, securities-driven securities loans are not shadow banking activities – by intermediating the borrowing and lending of securities, Lending Agents are engaging in an activity that the Agencies have long recognized as an essential part of the usual business of banking and the functioning of capital markets.[40]

Moreover, minimum SFT haircuts are designed to reduce the risk of financial instability arising from fire sales of collateral underlying SFTs.[41] Prior to the FSB's recommendations, former FRB Governor Jeremy Stein considered the issue and various approaches to addressing fire sale risk. In contemplating incorporating minimum haircuts for SFTs in the capital framework, Governor Stein presciently warned that doing so "would involve a significant conceptual departure from the notion of capital as a prudential requirement at the firm level."[42] In addition, he noted that a minimum SFT

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38 12 CFR § 217.2; 71; Prohibited Transaction Exemption (PTE) 2006–16; Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans, 71 Fed. Reg. 63786, 63796 (Jan. 1, 2007) ("General Conditions For Transactions Described in Sections I(a) and I(b)… The plan receives from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower, (1) 'U.S. Collateral' having, as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than 100 percent of the then market value of the securities lent…"); 17 CFR § 270.17f-2(c) (relating to RICs).

39 FSB, "Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" (Aug. 29, 2013), *available at* https://www.fsb.org/wp-content/uploads/r_130829b.pdf.

40 *Supra* note 4.

41 *See* Jeremy C. Stein, "The Fire-Sales Problem and Securities Financing Transactions" (Oct. 4, 2013), https://www.federalreserve.gov/newsevents/speech/stein20131004a htm.

42 *Id.*

haircut applied to banking organizations may lead to disintermediation in the SFT market, making it "hard to argue that the underlying fire-sales problem has been addressed."[43]

In this way, the Proposal's minimum haircut floors inappropriately push the bounds of what capital standards are meant to address, potentially increasing the risk to both individual banking organizations and to the financial system as a whole. In its thoughtful policy advice on minimum SFT haircuts, the EBA pointed out that "from a prudential perspective the minimum haircut floors framework if implemented in the capital framework as envisaged in the Basel standards could theoretically lead to a more risky situation for institutions than the status quo."[44] As such, implementing SFT haircuts, in addition to impairing market function, may increase the risk to both a particular banking organization and to the financial system.

Implementing minimum SFT haircuts would also make the United States an outlier and defeat the Proposal's purpose of harmonizing capital standards across jurisdictions. As far as we are aware, no major jurisdiction has implemented or proposed minimum SFT haircuts as part of its Basel III endgame reforms. By contrast, jurisdictions such as the European Union and the United Kingdom have recommended continued deliberation on the need and design of minimum SFT haircuts. Specifically, the European Union proposes to require European regulatory bodies "to report . . . on the appropriateness of implementing in the [European] Union the minimum haircut floors framework applicable to SFTs."[45] Similarly, the United Kingdom's Prudential Regulatory Authority "will consider whether implementation in the capital framework is appropriate in due course, taking into account data available under SFT reporting."[46] Given that, in contrast to the United States, both the European Union and United Kingdom have been collecting data on SFTs for a significant period of time, it would be especially premature for the Agencies to implement minimum SFT haircuts.

Recommendation

The final rule should not impose minimum haircuts for SFTs. Minimum haircuts for SFTs are an empirically untested idea based on a misunderstanding of the business of banking and not well-suited for inclusion in the bank capital framework. Implementing minimum SFT haircuts would impose unnecessary burdens on our Lending Agents, who are not engaged in the "shadow banking" activities that the rule seeks to address and may actually increase risk to the financial sector.

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43 *Id.*

44 EBA, "Policy Advice on the Basel III Reforms on Securities Financing Transaction (SFTs)," EBA-Op-2019-09d at 18 (Aug. 19, 2019), *available at* https://www.eba.europa.eu/documents/10180/2886865/Policy+Advice+on+Basel+III+reforms+-+SFTs.pdf [hereinafter, "EBA Policy Advice"].

45 European Commission, "Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor," COM/2021/664 at 27 (Oct. 27, 2021), *available at* https://eur-lex.europa.eu/resource.html?uri=cellar:14dcf18a-37cd-11ec-8daf-01aa75ed71a1.0001.02/DOC_1&format=PDF.

46 England Consultation Paper 16/22 at 1.5 n. 3.

B. Alternatively, the Proposal's approach to minimum haircuts for SFTs should be modified to avoid disruptive market practices and be more risk-sensitive.

Alternatively, if the Agencies are determined to include minimum haircuts for SFTs in the final rule, we recommend modifying the Proposal to ensure alignment with market practices and avoid unintended consequences on a Lending Agent's ability to continue to participate in the securities borrowing and lending markets. We believe that our recommendations are in the same spirit as the exemptions that the Agencies propose but modified in a way so as to make them more straightforward to operationalize in practice.

Specifically, we make the following recommendations:

1. Haircut floors for SFTs involving non-defaulted government-sponsored enterprise ("GSE") exposures should be 0%.

As discussed above, to recognize the risk mitigation benefit of financial collateral, the collateral haircut applicable to the transaction must be higher than the assigned haircut floor. The Proposal only assigns a floor of 0 to two types of collateral: cash on deposit and sovereign exposures that receive a 0% risk weight.[47] Debt securities are then divided by maturity, with longer debt receiving a higher floor, and index equities are separately set at a haircut of 6. All other exposures are set at 10. While we appreciate some of the attempts to differentiate between high-risk and low-risk exposures, the differentiations appear to be largely arbitrary and seem to contradict some of the risk-sensitive approach that was taken in assigning risk weights to the exposures themselves. Most relevant to Lending Agents, the CHA would lump exposures to GSE securities with all other securities, despite distinguishing them in the earlier credit risk framework (where they receive a 20% risk weight). GSEs are safer forms of collateral than the average debt security and actually help Lending Agents manage long-term rate risks. As evidenced by their extensive use as a part of Federal Reserve monetary policy, the market for GSE securities is highly liquid, including during stress periods.[48] Accordingly, SFTs involving GSEs present minimal credit and liquidity risk and should not be considered in-scope for minimum SFT haircuts. Non-defaulted GSE exposures should receive a 0 haircut floor.

2. The Proposal's exemption for transactions in which the Lending Agent reinvests cash collateral at the same or a shorter maturity than the original transaction should be better calibrated to reflect evolving industry practice regarding investment of cash collateral.

As described above, Lending Agents lend securities on behalf of numerous (sometimes hundreds) of beneficial owners on a demand (effectively overnight) basis. In order to maximize operational efficiency and take advantage of economies of scale, Lending Agents typically manage collateral received on a pool basis under a master securities loan agreement or global master securities lending

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47 Table 2 to § __.121.

48 *See* Proposal at 64139 ("GSE debt instruments guaranteed by the GSEs consistently trade in very large volumes and, similar to U.S. Treasury securities, have historically been able to rapidly generate liquidity for a banking organization, including during periods of severe market stress.").

agreement, including by reinvesting the cash collateral they receive, in liquid investments (including in U.S. Treasury and agency securities, CDs and commercial paper, among other instruments). At the end of each business day, or on the following business day, the Lending Agents will allocate collateral proportionally among the various beneficial owners.

The Proposal's exemption for transactions in which the Lending Agent reinvests cash collateral at the same or a shorter maturity than the original transaction therefore does not accurately reflect market practice and should be replaced with a broader exclusion (based on definitions in the SEC's Rule 3a5-3) for any "transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties." Adapting an existing SEC regulation with an established body of interpretation to distinguish between securities lending transactions and other securities financing transactions will help to minimize the risk of any evasion.

3. The Proposal's exemption for purpose-driven SFTs should incorporate the requirements of Regulation T and reflect the range of securities loans that are driven by the borrower's need.

Although we appreciate that the Proposal's exemption for purpose-driven SFTs would exempt SFTs that are within the scope of the FRB's Regulation T, we recommend that the exemption incorporate the requirement of Regulation T that broker-dealers borrow "for the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations" so as to promote regulatory consistency.[49]

Similarly, the final rule should clarify, in line with Regulation T, that the exemption for purpose-driven SFTs covers transactions in which "[a] creditor . . . lend[s] foreign securities to a foreign person (or borrow[s] such securities for the purpose of relending them to a foreign person) for any purpose lawful in the country in which they are to be used."[50] Doing so would avoid disadvantaging foreign subsidiaries of U.S. banking organizations, in addition to promoting further regulatory consistency.

Moreover, the text of the exemption should appropriately reflect the range of SFTs driven by a borrower's need or use. Accordingly, the exemption should clarify that it covers transactions in which the borrower has a current or reasonably anticipated near-term use or need for an equivalent or greater amount of securities related to:

- settlement or delivery obligations;
- custodial possession, control or safekeeping requirements;
- upcoming securities loans, repurchase transactions or other securities financing transactions it is making; or

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[49] *See* 12 CFR § 220.10(a).

[50] 12 CFR § 220.10(b).

- other similar requirements.

4. For the avoidance of doubt, the final rule should clarify that representations made as part of a master agreement fulfill the documentation requirements referred to in the Proposal for the exemption for purpose-driven SFTs without a need for transaction-level documentation.

As mentioned above, industry standard master securities loan documentation requires U.S. broker-dealer borrowers to make certain representations regarding the purpose of their borrowings. The exemption for purpose-driven SFTs, however, does not clarify whether documentation of reliance on such an exemption would have to be made on a transaction-by-transaction basis. We recommend that the Agencies clarify that documentation of compliance with this exemption could be met by including appropriate representations in the relevant master agreements consistent with industry practice.

Alternatively, the final rule should provide that the documentation requirements may be satisfied by the books and records of a borrowing entity reflecting the borrowing entity's needs and uses (rather than any transaction-level documentation).

5. To avoid creating a cliff effect that may increase risk in the financial system, the final rule should allow for partial recognition of collateral in netting sets that do not comply with the portfolio haircut floors.

Securities loans, particularly for Lending Agents, tend to form parts of large netting sets. The failure of a single transaction to meet the minimum haircuts due to a lapse in documentation or as the result of an operational error resulting in a margin deficit does not meaningfully change the risk-mitigating effects of collateral securing the loans in the netting set and therefore should not "taint" the entire netting set. By having the benefits of a netting set eliminated completely when the set falls beneath the minimum haircut, the Agencies artificially increase the value of taking measures to bring a set above the floor even if the difference is minimal. For example, if a netting set's minimum haircut is 10 but the set slips to 9.99, then the Lending Agent would be incentivized to make costly changes to the set to move it back above 10 and retain it there as otherwise the netting set's value (from a capital ratio standpoint, at least) is completely eliminated. However, the .01 difference likely has no material difference from a risk perspective.

6. The level of collateral used to assess compliance with the minimum haircuts should be determined on the basis of the contractually required margin, rather than real-time, minute-to-minute collateral levels.

Under the Proposal, minimum haircuts would appear to be based on the real-time fair values of the exposure and collateral, meaning that fluctuations in the value of the securities or collateral between when margin calls can contractually be made could result in minimum haircuts being breached. Under the current rule, "repo-style transactions" (to which the minimum haircuts would apply) are required to be marked to market daily and subject to daily margining requirements. Applying minimum haircuts on the basis of contractual margin would be fully consistent with the Agencies'

objective of incentivizing compliance with minimum haircuts without requiring banking organizations to modify longstanding margining practices.

C. The final rule should permit banking organizations to elect to apply the revised CHA in lieu of the current CHA for standardized approach purposes.

The Proposal would replace the modelled approaches for valuing exposures to repo-style transactions and eligible margin loans with a Basel-compliant revised version of the standardized CHA but would only implement the revised CHA as part of the expanded risk-based approach ("ERBA") and not the standardized approach.

Thus, banking organizations would apply two versions of the same methodology to compute exposures to the same transactions. While differences in risk weights under ERBA and the standardized approach can be explained in part by the separate capitalization of operational risk under ERBA, there is no foundation on which to justify different exposure quantification methodologies, particularly where the differences do not reflect differences in operational risk characteristics but rather recognition of diversification and netting.

Moreover, the Agencies' approach would be inconsistent with their approach for counterparty credit risk for derivatives. Currently, non-advanced approaches Lending Agents may elect to apply the standardized approach to counterparty credit risk ("SA-CCR") to quantify exposure to derivatives. This permits Lending Agents that invest in the operational capability to implement SA-CCR to avail themselves of that measure without imposing the burden of that implementation on smaller organizations for which the increased risk-sensitivity would not be meaningful.

Finally, if the Agencies' estimates that ERBA would be a binding constraint for virtually all affected banking organizations are correct, not applying the revised CHA under the standardized approach would mean that exposures arising from the same activity conducted at different institutions would be quantified in different ways.

To the extent that the Agencies retain both the current and revised CHA, we recommend that banking organizations be able to elect to adopt the revised CHA for purposes of the standardized approach calculation. Although we acknowledge that the revised CHA is more complex than the CHA (an inevitable result of increased risk sensitivity), the implementation of which could impose a large burden on small organizations, Lending Agents not subject to ERBA should be able to decide for themselves whether to avail themselves of the revised CHA, which the Agencies acknowledge is more risk-sensitive, recognizing the benefits of diversification.[51]

Recommendation(s)

We recommend allowing all banking organizations to opt in to the revised CHA approach for purposes of the standardized approach, consistent with the Agencies' approach to SA-CCR implementation.

[51] Proposal at 64061 ("Under the collateral haircut approach, the proposal would provide a new, more risk-sensitive equation that recognizes diversification benefits by taking into consideration the number of securities included in a netting set of eligible margin loans or repo-style transactions.").

D. The final rule should amend the CHA to provide that, at the banking organization's option, haircuts for ETFs will be determined based on their underlying holdings, not at the ETF level.

An indexed exposure to a basket of securities, like an ETF, is a cost-effective way to diversify exposure (without having to incur transaction costs associated with buying and selling individual securities). Economically, the value of a share of an ETF that is linked to an index will move in lockstep with the movement of the individual securities that comprise the index.[52] To the extent the ETF consists of low-volatility securities, such as U.S. Treasury or sovereign securities, the ETF would exhibit similarly low volatility. Requiring ETFs to be haircut as equity securities could depart significantly from economic reality, depending on the ETF's underlying holdings, and could discourage use of ETFs to diversify Lending Agents' collateral pools, contributing to increased concentration risk.

Recommendation(s)

We recommend that for the purposes of determining haircuts under the CHA, interests in ETFs should be treated as pro rata interests in the ETF's underlying holdings if so elected by the banking organization.

E. The final rule should disregard 0%-risk-weight sovereign securities when determining the largest E_S in the calculation of "N" in the revised CHA formula.

Under the Proposal, a Lending Agent with an exposure to a netting set of eligible margin loans or repo-style transactions would be able to recognize diversification benefits based on the number of securities included in the netting set, represented as "N" in the exposure formula.[53] However, without exception, the instruments that may be included in "N" are limited to 10% of the largest absolute value of a net position in a given instrument or in gold in the netting set.

$$E^* = max\left\{0; \left(\sum_i E_i - \sum_i C_i\right) + \left(0.4 \times net_{exposure}\right) + \left(0.6 \times \frac{gross_{exposure}}{\sqrt{N}}\right) + \left(\sum_{fx}\left(E_{fx} \times H_{fx}\right)\right)\right\}$$

The Proposal would provide for a new method to calculate the exposure amount for single-product netting sets of individual eligible margin loans and repo-style transactions that is designed to be more risk-sensitive.[54] In particular, the formula is designed to account for the risk-mitigating

[52] *See, e.g.*, Travis Box, Ryan Davis, Richard Evans and Andrew Lynch, "Intraday Arbitrage Between ETFs and Their Underlying Portfolios," Journal of Financial Economics at 1 (Feb. 15, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3322400 ("Panel vector autoregression shows ETF returns largely follow the underlying returns").

[53] Proposal at 64060.

[54] *Id.*

benefits of both netting and portfolio diversification.[55] However, as designed, the limitation on "N" based on the largest E_s in a netting set would be distorted by portfolios with large quantities of government securities.

The securities lending and repurchase market for government securities is characterized by high volumes and low margins, interest and fees. The typical transaction size in this market is far higher than in the market for equity securities. As a result, the largest individual E_s in a particular netting set that includes government securities is likely to be skewed by certain CUSIPs of government securities. Consequently, banking organizations that have portfolios with a diverse range of equity securities in addition to government securities would not be able to recognize much of the benefit of diversification within that asset class, notwithstanding the significant diversification benefit that those equities provide. Where the sovereign security would otherwise receive a 0% risk weight, it would not skew the risk of the netting set, so the benefits of diversification are still realizable.

Recommendation

We do not object to a 10% limit conceptually, but in order to make the "N" parameter meaningful, we recommend that the limit exclude net positions in sovereign securities where the sovereign exposure would be assigned a 0% risk weight under the final rule.

F. The Agencies should clarify, or the final rule should provide that, exposures to an index of securities, including ETFs, should be treated as an exposure to the underlying securities, not the index as a whole, for the purposes of calculating the "N" parameter.

As described above, the objective of the N-Factor is to recognize the risk-mitigating benefits of portfolio diversification. An indexed exposure to a basket of securities, including ETFs, is a cost-effective way to diversify exposure (without having to incur transaction costs associated with buying and selling individual securities). If an indexed exposure is considered at the index-level instead of the individual security level, it disregards the diversification the index provides, inconsistent with the purpose of the "N" parameter and might result in any small equity exposures in the netting set being excluded as well if they are less than 10% of the indexed exposure's cumulative value. Further, it would open up the rule to potential evasion, as a Lending Agent could increase its "N" parameter without increasing diversification by simply splitting a number of identical securities under different indexes.

Recommendation

The Agencies should clarify, or expressly provide, in the final rule that exposures to an index of securities in a netting set will be treated as an exposure to the underlying securities, subject to the same *de minimis* limits (calculated based on the pro rata ownership of each underlying security). This would avoid a meaningless distinction between indexes and their underlying securities and better carry out the objective of the "N" parameter.

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55 *Id.* at 64061.

G. The Agencies should clarify or the final rule should provide that where a repo-style transaction can be settled through the delivery of the applicable security or by cash in lieu of securities, the "settlement currency" is the currency in which the security or required cash is denominated and not the cash settlement currency identified in the relevant master securities lending agreement.

As has been described to the Agencies in the past, the current CHA treatment of currency mismatches does not properly account for transactions where, under the master agreement, delivery can be made by security or cash in lieu of the security. Understood plainly, the Proposal would not remedy this misunderstanding of the nature of agency lending.

In a repo-style transaction between a Lending Agent and a counterparty, the Proposal would require accounting for any mismatch between (i) the collateral and the settlement currency and (ii) the loaned securities and the settlement currency. However, most Lending Agents will provide in the master agreement to the transaction that in the case of a default, the Lending Agent may liquidate the collateral, and the counterparty will be responsible for any remaining amount in the applicable security's currency. Thus, the only relevant currency mismatch is between the securities and the collateral.

This is especially pertinent if the security and collateral are denominated in the same currency, but the settlement currency is denominated differently, as the Proposal would factor two mismatches into the risk weight calculation when such mismatches are not relevant in a default scenario. For example, if a Lending Agent lends a security denominated in pound sterling and receives collateral of another security denominated in pound sterling, then so long as the settlement currency is designated as U.S. dollars, the Proposal would require a haircut for the mismatch between the settlement currency and both securities even if a master agreement would allow the Lending Agent to liquidate the collateral and require the counterparty to pay any remaining amount in pound sterling.

As the currency mismatch haircut is meant to recognize the borrower's "increased risk of default due to the borrower's exposure to foreign exchange risk," the ability to liquidate collateral and pay the remaining amount in the currency in which the collateral was denominated allows the Lending Agent to recoup its losses without regard to the settlement currency or any currency mismatches it instigates.[56]

Recommendation

Thus, to avoid this unnecessary cost, the Agencies or the final rule should make clear that in a securities financing transaction where settlement can be made through delivery of the security or through cash in lieu of the security, the "settlement currency" is the currency in which the security is denominated for the purposes of determining any mismatch.

[56] *Id.* at 64053.

H. The final rule should establish a transition period to phase out internal models-based approaches for purposes of the SCCL, permitting firms, on an optional and transitional basis, to recognize the difference between the modelled approach and the revised CHA.

The Proposal would eliminate model-based approaches (except with regard to market risk). For Lending Agents that currently use internal models or simple VaR to calculate exposure amounts for securities financing transactions or derivatives, such elimination would significantly increase credit exposure amounts calculated for purposes of the SCCL.

Under current SCCL regulations, qualifying Lending Agents can use any FRB-permitted method, including internal models, to measure exposure to repo-style transactions.[57] However, as the Proposal would remove model-based approaches as a permitted option for measuring exposure to repo-style transactions, qualifying Lending Agents would no longer be able to use internal models for purposes of the SCCL exposure calculations (for repo-style transactions) without any transition period.[58] This would result in a sharp and sudden upsurge in credit exposure amounts under the SCCL for a given constant portfolio of transactions with no real change in economic risks.

The Agencies provided a transition period for ERBA and Accumulated Other Comprehensive Income ("AOCI") because they recognized that banking organizations need "sufficient time to adjust to the proposal while minimizing the potential impact that implementation could have on their ability to lend."[59] We agree with the Agencies' analysis that such changes require a transition period but contend that the same concerns necessitate an optional transition period for the Proposal's effects on SCCL. Lending Agents may require sufficient time to adjust to the changes to credit exposure amounts under the SCCL to avoid the market dislocations that would inevitably occur if the changes were implemented at once.

Recommendation(s)

Therefore, we recommend that the final rule provide for a three-year transition period whereby Lending Agents currently relying on internal models-based approaches could, at their option, recognize 20%, 15% and 10% of the difference between the modelled approach and the revised CHA during the transition period. The timing of the transition should follow the three-year transition periods for ERBA and AOCI (if implemented in the final rule).

I. U.S. Treasury securities should continue to be exempt from the minimum haircuts.

Question 55 in the Proposal asks how "the inclusion of sovereign exposures [might] affect the market for those securities?" In a November 16, 2023 speech at the 2023 U.S. Treasury Market

57 12 CFR § 252.73(a)(4).

58 Proposal at n. 146.

59 *Id.* at 64166.

Conference, Vice Chair Barr reiterated this question, asking commenters for feedback on whether and to what extent sovereign securities should be subject to minimum haircut floors.[60]

As the Agencies' regulatory framework acknowledges in numerous places, including the current capital rule and the Agencies' quantitative liquidity requirements (the liquidity coverage ratio and net stable funding ratio requirements), U.S. Treasury securities are very low risk and highly liquid securities, essentially the equivalent of cash, given the ease with which they can be traded, bought and sold. Subjecting transactions on sovereign securities, including U.S. Treasury securities, to minimum haircuts would be highly disruptive to this multi-trillion-dollar market, would be without precedent or justification, and could exacerbate the risk of "flash crashes." Further, without parallel implementation abroad, the FRB and U.S. Treasury would be forced to place much heavier reliance on foreign banks to effectuate monetary and fiscal policy, respectively.

Recommendation(s)

U.S. Treasury securities should be exempt from minimum haircut requirements.

V. Operational Risk Capital

A. The services component of the business indicator should be reduced by capping the fee and commission income component to a set percentage of an institution-specific factor that takes into account other areas where operational risk contributes to capital requirements.

Under the Proposal, a Lending Agent's operational risk would be calculated in part through the "business indicator," a sum of three components: (1) an interest, lease and dividend component; (2) a services component; and (3) a financial component. The services component is designed to capture fee and commission-based activities, including fees generated through Lending-Agent lending.[61] Lending Agents act as agents for beneficial owners for a fee, and such fee is their primary source of income. The Proposal would subject such fees to new capital requirements, increasing the cost of participating in agency lending and likely forcing Lending Agents to pass on the increased capital requirements to consumers and end-users in the form of higher fees or reduced availability of services.

Participants looking to enter the space will also be disincentivized due to the increased cost of operating Lending Agent activities comparatively to other bank activities, leading the industry to contract. In particular, in certain cases, Lending Agents would incur a greater capital charge under the Proposal for fee and commissions-based activities than for other types of activities. For example, the interest income and expenses portion of the interest, lease and dividend component is subject to a ceiling equal to 2.25% of a Lending Agent's total interest-earning assets "[b]ecause operational risk does not necessarily increase proportionally to increases in net interest income."[62]

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60 Michael S. Barr, "The 2023 U.S. Treasury Market Conference" (Nov. 16, 2023), *available at* https://www.federalreserve.gov/newsevents/speech/barr20231116a.htm.

61 Proposal at 64084 and n. 184.

62 *Id.* at 64084.

We would contend that operational risk does not necessarily increase proportionally to increases in net fees or expenses for Lending Agents as well.

Further, also in the case of the interest, lease and dividend component, operational risks are measured on a net basis with respect to net interest income, or revenues less costs, while operational risks for the services component are measured on a gross basis with respect to the maximum of revenues and costs. As a result, bank businesses that are service-oriented, such as agency lending, by virtue of having operational risk measured on a gross basis, would tend to be assigned more operational risk than other businesses, such as direct lending, where operational risks are largely measured on a net basis. This inconsistency is highly artificial and does not correlate to the risks posed by each service.

Although the Proposal largely conforms to the Basel Framework, the Agencies have failed to adequately justify the appropriateness of the Basel standards themselves. The first Basel consultative document specifically acknowledged that the proposed operational risk framework "does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities."[63] The second consultative document also noted that the proposed operational risk approach would lead to "overcapitalisation of banks with high fee revenues and expenses."[64] However, the Proposal does not address the proposed adjustment in the second consultative document to account for this problem.

Lending Agents are also already subject to capital requirements based in part on their operational risk. For example, the stress capital buffer is calibrated using supervisory stress tests that include projections of operational risk losses.[65]

Recommendation(s)

We therefore recommend adjusting the calculation of the services component so it is not overrepresented in the business indicator formula. While there are many ways to accomplish this, we believe capping the fee and commission income and expenses to a set percentage of an institution-specific factor is a sound approach and would work in line with the cap on interest income and expenses already built into the Proposal.[66] The institution-specific factor should be geared toward each institution's idiosyncratic activities and take into account how the institution's

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63 BCBS, "Operational risk – Revisions to the simpler approaches," Consultative Document at 16 (Oct. 6, 2014), *available at* https://www.bis.org/publ/bcbs291.pdf.

64 BCBS, "Standardised Measurement Approach for operational risk," Consultative Document at 4 (Mar. 4, 2016), *available at* https://www.bis.org/bcbs/publ/d355.pdf.

65 *See*, *e.g.*, FRB, "2022 Federal Reserve Stress Test Results" at 12 (Jun. 2022), *available at* https://www.federalreserve.gov/publications/files/2022-dfast-results-20220623.pdf ("[Pre-provision Net Revenue] incorporates expenses stemming from operational-risk events, such as fraud, employee lawsuits, litigation-related expenses, or computer system or other operating disruptions. In the aggregate, operational-risk losses are $188 billion.");

66 With more data, other options may prove effective as well. If the Agencies issue a re-proposal, we would recommend considering the optimal design for adjusting the services component to ensure banking organizations that have large fee-based income are appropriately treated.

operational risk already contributes to capital requirements. This will help ensure that fees and commissions are more comparative to the other indicators and that fee and commission-based business are not unfairly treated.

B. In the calculation of operational risk, the ILM should be set at 1.

For purposes of the expanded approach, the Proposal would adopt the Basel Standardised Measurement Approach framework, including the treatment of fee income and expense, but would not exercise national discretion to set ILM = 1 except for banks that have less than five years of compliant operational loss data (and further subject to a reservation of authority that allows increases in operational risk requirements, e.g., for deficient operational risk management). The Proposal also does not adopt the BCBS recommendation, which does not set a floor at 1 for ILM, allowing banking organizations with few losses to reduce their operational risk capital requirements.

The Agencies' approach is not in line with the approaches taken by the UK or the EU, each of which sets ILM = 1 and recognizes that the formulaic link to past losses proposed by BCBS does not properly account for losses. The UK lays out particularly convincing points in its release to keeping the ILM = 1, including:

- The calculation of ILM is non-linear, so operational risk capital requirements increase more slowly than historical losses;
- The ILM calculation does not properly factor for the "fat-tailed" nature of loss-distribution, characterized by infrequent but very large losses;
- The 10-year window for calculating the average of past losses is inappropriately affected by large historical operational risk losses near the start of the 10-year period that might be a weak predictor of future losses. This, combined with the "fat tailed" nature of losses, means that a firm that suffered an improbable but large loss would pay for it in its capital requirements for 10 years, even if there is no evidence that the loss is likely to be repeated;
- Evidence suggests that size, rather than the amount of past losses, is the dominant differentiator of operational risk, making ILM an unnecessary measure;[67] and
- Applying a variable ILM could have different, and possibly material, impacts on different firms with different business models, which could have unintended consequences for competition and create inconsistency.[68]

The Proposal is also out of step with the Basel Framework because it neither sets ILM = 1 nor simply applies the Basel Framework's operational risk formula and instead applies the formula with a floor of 1. This guarantees that any U.S. banking organization would have an ILM equal to or greater than a UK or EU equivalent. It also would reduce a Lending Agent's incentive to reduce

[67] BCBS, "Operational risk - Revisions to the simpler approaches" at 2 ("the size of a bank was a dominant factor in operational risk exposure").

[68] England Consultation Paper 16/22 at 8.24 & 8.28.

losses once it reaches an ILM of 1, incentivizing risk taking. Finally, though the Basel Framework's formula does not explicitly set out a floor, the natural log (ln) function in the formula creates a floor by nature of the operation (ln(e-1) or about .54), so there was already a natural lower limit to ILM that provides the "robust minimum amount of coverage" the Agencies evoked to justify the floor.[69] The Proposal's floor is thus a solely punitive measure.

Recommendation(s)

We would therefore recommend that ILM be set to 1 in line with the UK and EU proposals. Alternatively, if the ILM cannot be set to 1, we recommend at least removing the floor of 1, allowing the ILM to increase and decrease freely based on the Lending Agent's operational losses.

VI. Market Risk Capital and CVA

A. The final rule should exempt commercial end-users from CVA requirements.

Commercial end-users, like farmers and manufacturing businesses, and financial end-users, like pension funds and insurance companies, rely on derivatives to hedge their risks. Farmers use futures or other derivatives to protect against sudden price swings in their crops; manufacturing businesses operating overseas use them to hedge foreign exchange risk and pension funds use them to hedge interest rate or longevity/mortality risk so that beneficiaries can be assured of their savings come retirement. Because these derivatives are often entered through banking organizations subject to the Proposal, the Proposal's CVA component would make it more expensive for end-users to serve their customers by imposing additional costs on such banking organizations for providing them. Businesses and public sector entities would face greater risk or higher operating costs, leading to either lower supply or higher prices for consumers and reduced profits for the businesses, including many small businesses. The Proposal would add this friction to the economy without an offsetting policy benefit.

Further, imposing this steep cost increase on commercial end-users would be inconsistent with statutory exemptions for commercial end-users from mandatory clearing and margin requirements for over-the-counter swaps.[70] These exemptions reflect the intent of both Congress and the Agencies to permit commercial end-users to continue managing risks without undue costs. To impose such costs in this context but not elsewhere would (i) undermine the goals of previous exemptions, (ii) be misaligned with international standards as, for example, the European Union exempts commercial end-users, as well as financial end-users, from CVA requirements and (iii)

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[69] Proposal at 64086.

[70] The Dodd-Frank Act exempted certain commercial entities from mandatory swaps and security-based swaps clearing. *See* 7 U.S.C. § 2(h)(7)(A); 15 U.S.C. § 78c-3(g)(1). The Terrorism Risk Insurance Program Reauthorization Act of 2015 expanded the exemption to exempt swaps from mandatory initial and variation margin requirements where one of the parties is a commercial end-user and uses swaps to hedge or mitigate commercial risk or is eligible for a public interest exemption from swaps clearing requirements for certain cooperative entities. *See* 7 U.S.C. § 6s(e)(4); 15 U.S.C. § 78o-10(e)(4). Separately, the Agencies and the Commodity Futures Trading Commission excluded swaps with commercial end-users from mandatory margin requirements under the Dodd-Frank Act, recognizing that such swaps pose less risk to the financial system. *See* Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840, 74848 (Nov. 30, 2015).

would go against the spirit of the capital framework's treatment of commercial end-users, which assigns a lower alpha factor to commercial end-users in the standardized approach for counterparty credit risk.[71]

Recommendation(s)

Accordingly, we recommend that the final rule exempt transactions with commercial and financial end-users from CVA requirements in line with international standards and with regard to commercial end-users, in line with the exemptions from mandatory clearing and margin requirements for over-the-counter swaps.

B. Alternatively, the treatment of central clearing should be modified to increase risk sensitivity.

To the extent the Agencies do not exempt commercial end-users from CVA requirements, the final rule should at least exempt a banking organization's exposure to its client resulting from the organization's guarantee (or similar financial intermediation) to a central counterparty of its client's obligations.

When a banking organization clears derivatives on behalf of a client, the central clearinghouse will often require the bank to guarantee the client's performance in order for the clearinghouse to have protection from the counterparty risk. Such exposure does not result in meaningful CVA risk for which additional capital requirements would enhance resilience, but the Proposal would still require banking organizations to include this in calculating CVA risk. By excluding all other elements of cleared transactions, but not this client-facing leg, the Proposal would increase the cost of hedging activities.

The FRB's separate proposal under the guise of changes to the G-SIB surcharge also includes central clearing transactions as part of two indicators (intra-financial system assets and intra-financial system liabilities in the interconnectedness category and notional amount of OTC derivatives in the complexity category).[72] Inclusion in these indicators increases the possibility that a banking organization would pass a prescribed threshold under the tailoring rules, subjecting the organization to further regulatory requirements and restrictions.

Both of these changes discourage the use of the central clearing. Many market participants choose to use central clearing (such as FICC sponsored repo) because of its scalability and liquidity. Because most commercial users cannot be direct members, many are required to be sponsored into the central counterparty and should not be unfairly targeted. By discouraging central clearing, the Agencies would potentially (i) cause exits from the market, increasing costs to end-users, (ii) harm financial stability[73] and (iii) put U.S. organizations at a competitive disadvantage because the Basel

[71] EBA CRR, Article 382.

[72] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y–15), 88 Fed. Reg. 60385 (Sept. 1, 2023). While a separate proposal, we believe both of these changes are interconnected and should be considered together.

[73] As Chair Powell has explained, central clearing "serves to address many of the weaknesses exposed during the [2007-2008 financial] crisis by fostering a reduction in risk exposures through multilateral netting and daily margin

Framework excludes from the complexity category cleared OTC derivative transactions in which the banking organization, acting as agent, does not guarantee the performance of a central counterparty clearinghouse to its client.[74] Inclusion in the complexity category is at odds with the policy objections of the G-SIB surcharge and the complexity indicator more specifically because clearing increases standardization and improves market transparency, both of which reduce complexity and systemic risk in the system.

Recommendation(s)

The final capital and G-SIB rules should not include central clearing transactions in calculating CVA risk or as part of systemic indicators.

By adopting these recommendations, the Agencies would increase the risk sensitivity of the final rules, lower the cost for end-users to hedge their risks and, accordingly, reduce overall risk in the financial system. Moreover, it would be a step towards harmonizing international capital requirements.

C. Only the cash leg of term repo-style transactions should be considered under market risk.

Under the current rule, term repo-style transactions are included in market risk, but only with regard to the interest rate and repo spread (i.e., the cash leg), ignoring the securities component of the transaction for the purpose of market risk (i.e., the securities leg). The Proposal would require Lending Agents to capture risk factor sensitivities of the cash leg to general interest rate risk and of the security leg to credit spread risk, equity risk, commodity risk and foreign exchange risk, as applicable.[75] Including the security leg in market risk is a fundamental departure from what is considered market risk exposure and therefore creates a material disconnect between the capital calculation and economic market risk profile. Critically, when a banking organization engages in a term repo-style transaction, it does not face direct market price risk or issuer-default risk on the security collateral, which is what market risk is meant to cover. To the extent the security collateral's value is affected, the banking organization would only have contingent risk based on the counterparty's chance of default (as opposed to the issuer), which should be captured in the Proposal's exposure at default calculation under the counterparty credit risk rules, not the market risk rules.

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requirements as well as greater transparency through enhanced reporting requirements." Jerome H. Powell, "Central Clearing and Liquidity" (Jun. 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm. The SEC also recently finalized a rule that would essentially require central clearing of certain transactions involving U.S. Treasury securities. SEC, "Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities," RIN 3235-AN09 (Dec. 13, 2023), *available at* https://www.sec.gov/files/rules/final/2023/34-99149.pdf.

[74] Jerome H. Powell, "Central Clearing and Liquidity" ("Central clearing also enables a reduction in the potential cost of counterparty default by facilitating the orderly liquidation of a defaulting member's positions, and the sharing of risk among members of the CCP through some mutualization of the costs of such a default.").

[75] Proposal at 64148.

A term repo-style transaction is an exposure to the counterparty and the rate of the transaction. The former should be treated as a counterparty risk, and the latter should be treated as an interest rate risk. Only the interest rate risk should be considered in the market price risk of a term repo-style transaction.

Recommendation(s)

Accordingly, the market price risk and issuer default risk of the collateral in a term repo-style transaction should not be included in market risk. The market price risk of the term repo-style transaction (i.e., interest rate risk) should be included in market risk, consistent with the current rule.

D. Sector buckets under the sensitivities-based method should distinguish between safer financial institutions, such as RICs and Pension Funds, and riskier nonbank financial institutions.

Under the sensitivities-based method in the Proposal, counterparties are divided by sector in order to determine appropriate risk weights for specific risk factors. As proposed, all financial institutions would generally be put in the "financials" sector, treating all financial institutions of the same credit quality category equally. For example, an investment grade exposure to a Pension Fund will have the same treatment as an investment grade exposure to a hedge fund, despite their different risk profiles.[76] This treatment is inconsistent with the risk-sensitive aims of the Proposal and should be amended to take into account the different risk profiles presented by different types of financial institutions.

Recommendation(s)

The final rule should have sector buckets that distinguish between safe financial institutions and less safe financial institutions. At the very least, the safe financial institutions should include well-capitalized and adequately capitalized banks, RICs and Pension Funds.[77]

E. The net default exposure methodology for non-securitization debt or equity positions should permit treating rolling equity hedges as if they match the maturity of the positions they are hedging.

Under the Proposal, Lending Agents would only be permitted to treat short and long market risk covered positions as fully offsetting if the positions have "maturities greater than one year or positions with perfectly matching maturities provided other criteria are met such as if both long and short positions reference the same obligor and the short positions have the same or lower seniority as the long positions."[78] This methodology fails to take into account rolling equity hedges, which have a stated maturity but can be continuously rolled forward to hedge for longer maturity

[76] See our discussion in Section 0 for reasons Pension Funds are safe exposures.

[77] See our discussion in Section II.A and 0.

[78] Proposal at 64125.

instruments. For example, a one-year equity swap can be hedged with a three-month rolling equity future because the future can be rolled three times to match the maturity of the swap. The rolling feature provides the Lending Agent with similar protections but also gives it flexibility, so such arrangement should be encouraged.

Recommendation(s)

Lending Agents should be permitted to assign rolling equity hedges a maturity that matches (i) the positions they are hedging or (ii) as close to the maturity of the positions they are hedging as permitted by the terms of rolling equity hedge.

F. Banking organizations should be permitted to assume a MPoR of 4+N for all derivative transactions.

To determine collateral available to a banking organization at a given exposure measurement time, the Proposal would require banking organizations to assume a counterparty will not post or return collateral until the conclusion of an MPoR.[79] The minimum MPoR would depend on the type of CVA risk covered position at issue, with client-facing derivative transactions receiving a minimum of 4+N business days and other derivative transactions receiving a minimum of 9+N, where N is the re-margining period in the margin agreement. This effectively makes the minimum MPoR 5 and 10 business days, respectively. The Proposal does not offer any justification for treating client-facing and non-client-facing derivatives differently, even though both are subject to uncleared margin rules that require daily margining and, as the Proposal acknowledges, both may be subject to margin agreements with daily or intra-daily exchange of margin. Further, for derivatives with daily margining requirements (by rule or agreement), it is unnecessarily punitive to require an MPoR of 10 days as that assumes the banking organization is out of compliance with the daily requirement.

Recommendation(s)

All derivatives should have a minimum MPoR of 4+N. Treatment will not be dependent on whether the derivative is client-facing.

G. Proper hedges of non-modellable risk factors should be recognized in calculating RWAs.

Under the Proposal, the treatment of non-modellable risk factors provides significantly less recognition for hedging than for modellable risk factors.[80] Non-modellable risk factors generally include risk factors that are less liquid because they are defined based on the Lending Agent's ability to identify a sufficient number of real prices that are representative of the risk factor.[81] However, a risk factor's liquidity does not reflect the ability to hedge the risk. Products with non-

[79] *Id.* at 64160.

[80] *Id.* at 64131 ("Relative to the IMCC for modellable risk factors, the SES calculation for non-modellable risk factors would provide significantly less recognition for hedging and portfolio diversification due to the lower quality inputs to the model").

[81] *Id.* at § __.214(b)(1).

modellable risk factors are able to be hedged in the course of regular risk management and are key tools to manage risks. The non-modellable risk factor approach should permit Lending Agents to recognize these proper hedges, even if limitations are placed on the amount of netting that can be recognized. This would align with the approach taken to credit and equity products in the sensitivities-based method, which applies correlation parameters to liquid and non-liquid products.[82]

Recommendation(s)

The final rule should recognize proper hedges in modellable and non-modellable risk factors.

VII. Clarification(s)

A. The Agencies should clarify that sovereign wealth funds are PSEs under the final rules.

The Proposal generally distinguishes between PSEs and other entities because PSEs are safer and backed by a governmental entity. Under the current rule, PSEs are defined as "a state, local authority, or other governmental subdivision below the sovereign level," but the Proposal and the current rule do not make it clear that a sovereign wealth fund qualifies as a PSE.[83] Sovereign wealth funds are government-owned instrumentalities, and the substance of the relationship is similar to that of a government agency. A government's choice to invest directly or through a fund should therefore not affect the risk presented and should receive the same treatment under the rule.

Recommendation(s)

In guidance or in the final rule, the Agencies should make clear that sovereign wealth funds are PSEs.

VIII. Conclusion

We appreciate the opportunity to provide these comments and would be happy to engage in a more comprehensive dialog with the Agencies. We believe that achieving effective and efficient reform requires healthy and robust collaboration between supervisors and market participants.

The RMA Council would be pleased to meet with the Agencies or their staff to assist the Agencies in the development of any of the recommendations discussed in this letter or in any other manner as the Agencies undertake to implement the Basel Framework. The RMA Council stands ready to assist the Agencies as they continue to consider revisions to the Proposal.

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82 *See, e.g.*, *Id.* at Table 3 to § __.209 and Table 4 to § __.209 (including correlation parameters for speculative grade and sub-speculative grade credit).

83 12 CFR § 217.2.

Sincerely,

[redacted]

General Counsel
Risk Management Association

Chairman
Committee on Securities Lending
Risk Management Association