THE ASSOCIATION OF GLOBAL CUSTODIANS

BNY MELLON
BROWN BROTHERS HARRIMAN
CITIBANK, N.A.
DEUTSCHE BANK
HSBC SECURITIES SERVICES
J.P. MORGAN
NORTHERN TRUST
RBC INVESTOR & TREASURY SERVICES
SKANDINAVISKA ENSKILDA BANKEN
STANDARD CHARTERED BANK
STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:
BAKER & MCKENZIE LLP

EUROPE
ATT: ARUN SRIVASTAVA
100 NEW BRIDGE STREET
LONDON EC4V 6JA, ENGLAND
INT'L TEL: 44 20 7919 1000

GLOBAL
ATT: ROBIN TRUESDALE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL: 202 452 7000
FAX: 202 452 7074

WWW.THEAGC.COM

March 27, 2015

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

Via electronic submission: www.bis.org/bcbs/commentupload.htm

<u>Consultative Document – Revisions to the Standardized Approach for Credit Risk</u>

Dear Sir/ Madam:

The Association of Global Custodians ("AGC" or "Association") appreciates this opportunity to comment on the Consultative Document ("Consultation") issued by the Basel Committee on Banking Supervision ("Basel Committee") regarding revisions to the standardized approach for credit risk.

The Association is an informal group of eleven member banks that provide securities safekeeping and asset serving functions to cross-border institutional investors worldwide, including investment funds, pension funds, and insurance companies. While many of the Association's member banks have broad views regarding various aspects of the Basel Committee's Consultation, and several are submitting their own comment letters, our joint submission is solely focused on the treatment of agency-indemnified securities financing transactions ("agency-SFT"). Custody banks play a key role in agency-SFT by intermediating market access to pools of investment assets held by their institutional investor clients, used among other reasons, to facilitate market liquidity and efficiency, meet growing demand for high-quality collateral, and provide long-term investors with access to low-risk, incremental returns.

In spite of several references in the Consultation to the standardized approach for credit risk ("SA-CCR"), the Basel Committee appears to intend for exposures to securities financing transactions, including agency-SFT, to be measured using an amended and even more conservative version of the existing haircut-based 'comprehensive approach'. Indeed, the haircuts proposed by the Basel Committee are set at levels which are far higher than the haircuts demanded by the market, even in periods of financial market stress. The 'comprehensive approach' requires banking organizations to increase the value of securities placed on loan and the value of the offsetting collateral using pre-determined and highly-risk insensitive supervisory haircuts. This has the effect of greatly overstating credit risk in agency-SFT, and therefore the maximum potential loss that a banking institution may incur. Indeed, industry estimates indicate a potential 40 to 50 fold increase in exposures under the amended 'comprehensive approach' (factoring in proposed changes to counterparty risk-weights) versus exposures measured under simple value-at risk methodologies widely used by banks with large agency-lending programs.

This dramatic over-statement of risk reflects several pressing methodological limitations. As an example, the Basel Committee's proposed methodology fails to recognize the benefits of portfolio diversification within both lending and collateral pools, along with the effect of 'flight to quality' during periods of financial market stress, where certain securities can be expected to decline in value while other higher quality securities can be expected to increase in value. Similarly, this approach does not recognize the correlation that exists between securities placed on loan and the offsetting collateral received, assuming that the market value of securities will move in opposite directions at all times. Furthermore, this approach provides very limited scope for the netting of transactions, meaning that the larger the portfolio of trades, the greater the overstatement of credit exposure.

While the AGC does not oppose reasonable efforts to strengthen the regulatory environment for securities financing transactions, the inaccurate measurement of credit risk has the potential to lead to a further contraction in securities lending activities, with important negative implications for asset owners and the financial markets generally. We therefore strongly urge the Basel Committee to actively explore an alternative and appropriately risk-sensitive, non-internal model based methodology for the measurement of exposures to agency-SFT. This is consistent with comments made by the Basel Committee in its final framework for the measurement and control of large exposures[1], and we urge the establishment of a dedicated work stream to carry this important initiative forward. The concerns that we have raised with regards to the 'comprehensive approach' are quite similar to the issues that existed with the 'current exposure method' in the context of derivatives transactions. Just as the Basel Committee introduced a revised methodology for exposures to derivatives transactions (i.e. the SA-CCR), we ask that the Basel Committee do the same for agency-SFT.

There are a number of alternative approaches which have been raised by several of our member banks in discussions with various supervisory authorities. These include the 'regulatory input method', where supervisors provide all market assumptions for use in a pre-defined formula that incorporates the value of securities lent and the value of collateral received; the 'revised comprehensive approach', which is based on a re-designed haircut-based matrix that reflects correlation, diversification and other key factors; and, the 'SFT SA-CCR' which involves the adaptation of the existing exposure measure for derivatives for economically similar agency-SFTs. The Association views these suggestions as a useful contribution to the process of identifying an appropriate alternative methodology for agency-SFT, and we therefore urge the Basel Committee to give them serious consideration as it progresses in its work on a revised standardized framework for credit risk.

Thank you once again for the opportunity to comment. The AGC would be pleased to provide additional information on any of the points raised if desired by the Basel Committee.

Sincerely,

Rudy Gadenz
Chair, Association of Global Custodians

---

[1] 'Supervisory Framework for Measuring and Controlling Large Exposures', Basel Committee on Banking Supervision 9April 2014), Paragraph 34.