



**European Commission Legislative Proposal  
for a Revised Capital Requirements  
Regulation (CRR)**

The International Securities Lending Association (ISLA) welcomes the finalisation of the Basel III reforms in the European Union to further contribute to future financial stability and assist in the steady crisis recovery, post COVID-19.

The International Securities Lending Association (ISLA) is a leading non-profit industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. Its geographically diverse membership of over 170 firms includes institutional investors, asset managers, custodial banks, prime brokers and service providers.

Working closely with the industry, as well as national, regional, and global regulators and policy makers, ISLA advocates for, amongst other things, the importance of securities lending to the broader financial services industry. It supports both the Global Master Securities Lending Agreement (GMSLA) legal framework, including the Title Transfer and Securities Interest over Collateral variants, as well as the periodical enforceability and security enforcement across global jurisdictions.

ISLA supports the Commission's overall objectives to strengthen the risk-based capital framework and has provided general feedback to the proposal for a ***Regulation of the European Parliament and of the Council, amending Regulation (EU) No. 575/2013 as regards to requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor.***

Please note that ISLA has responded to amendments of various articles of the Capital Requirements Regulation proposal from the perspective of member firms actively engaged in securities financing transactions, in particular, securities lending, borrowing and subsequent collateral management.

## Article 519c, Minimum Haircut Floors framework on SFTs:

ISLA advocates the crucial role that securities financing transactions play in the smooth functioning of EU Capital Markets, supporting price discovery and secondary market liquidity and would like to take this opportunity to raise our memberships' broader concerns on the implications of the minimum haircut framework, related to non-centrally cleared securities finance transactions (STFs), with respect to securities lending and borrowing.

Members of the Association are supportive of the Basel Committee on Banking Supervision's (BCBS) and the Commission's overall policy goals and acknowledge that some SFTs may be used to take on leverage, as well as maturity and liquidity mismatched exposures, which may pose risks to financial stability.

However, we note that under the scope of the BCBS's rules as is currently drafted, a significant number of SFT transactions would be captured that are not entered into for the purpose of generating leveraged returns, such as securities lending and borrowing transactions. In an additional paper from the FSB other than the one referenced in the proposal, they state in a report<sup>1</sup> titled *'Transforming Shadow Banking into Resilient Market-based Finance'* in 2015 (and updated in 2020), that the framework looks to *'limit the build-up of excessive leverage outside the banking system, reduce the procyclicality of such leverage, guard against the risk of regulatory arbitrage, and maintain a level-playing field'* however, there is no distinction between specific transactions that are for the purpose of financing and therefore do increase leverage, and for transactions such as securities lending and borrowing, that are mostly used to source a particular security, rather than solely for financing. ISLA fear that this could unintentionally result in an increase in activity and intermediation, transferring these SFTs from banks to less regulated entities, thus not meeting the core purpose of the framework.

ISLA wish to re-highlight the potential unintended consequences that were raised in the EBA policy report for advice on the Basel III reforms on SFTs in August 2019<sup>2</sup>, as mentioned in the proposal – *'the consistent treatment would ensure a level playing field in the EU financial system and address all potential sources of*

*leverage outside the banking sector, while preventing the risk of regulatory arbitrage. Conversely, in the absence of a framework for non-bank-to-non-bank transactions, the application of haircut floors exclusively for bank-to non-bank transactions may just lead market participants to shift their activities in the shadow banking sector. It should be noted that this potential effect was also mentioned by institutions in their feedback for the purposes of the CfA.'*

ISLA strongly recommends that the Commission clearly excludes these types of SFTs (securities borrowing and lending) from the scope of the framework, as their purpose is outside the concern of the policy, and implementing the policy as it stands, could consequently affect the functioning of these types of transactions, with a negative effect on the market. It is important to note that securities lending is a low risk, discretionary activity for asset owners and investment managers, and any fundamental changes to the current market structure may result in pushing lenders away from the market, therefore reducing liquidity.

The most frequent motives for a bank to borrow securities are to source superior collateral to improve their liquidity position, for example through a collateral upgrade, as well as to facilitate client short sale transactions. Current market practice within the industry is for the party that is initiating the borrow, to pay the haircut on the collateral delivered. The haircut is not determined by the relative asset quality of the two legs, or credit worthiness of the two parties. The framework should make clear that it is applicable to the party receiving the collateral and hence the party determining the haircut, and not the collateral provider, who as the haircut payer, will always fail to meet the minimum haircut threshold.

The exclusion of the haircut payer in securities borrow transactions, should be further independent of:

- a) the type of collateral posted to the lender (non-cash securities or cash) and;
- b) whether the lender can re-pledge or re-sell the securities collateral received respectively;
- c) how any cash collateral received is re-invested by the lender.

The vast majority of securities are borrowed from large custodian agent lenders, where non-cash

collateral is usually held by a tri-party collateral manager acting on behalf of the agent lender and the borrower, and therefore these securities are not generally rehypothecated, thus the lender will not be able to create leverage in this way.

*As per the 2016 ESMA report referenced in the proposal<sup>3</sup> which states that ‘numerical haircut floors for non-centrally cleared transactions, such as those set out by the FSB, can only be introduced and calibrated following a thorough analysis using granular SFT data (which will become available after the full implementation of the Securities Financing Transaction Regulation (SFTR), and following careful assessment of the scope)’.*

As the final stage of SFTR implementation entered into force in January 2021, ISLA agree that further analysis is required prior to implementation of these rules and support the Commission providing the EBA’s mandate to report, in close cooperation with ESMA, on the appropriateness of implementing minimum haircut floors. ISLA propose that this is reviewed as part of the upcoming SFTR legislative review, expected in 2022.

## **Standardised Approach:**

ISLA wish to note that the upcoming regulatory changes introduced through the Capital Requirements Regulation and Directive, will not just impact regulated credit institutions but also have implications for asset owners and the broader EU capital market.

ISLA members are most impacted by changes to the output floor, that requires a bank's Risk Weighted Assets (RWA) to not be lower than 72.5%, as calculated using the standardised approach.

ISLA support the transitional arrangements for the output floor as noted in Article 465 (1) starting from 50% during the period from 1st of January 2025 to the 31st of December 2025 however, RWA allocated to securities financing is expected to increase dramatically as a result.

The new rules also include a 100% RWA to unrated funds, which ISLA determine to have a substantial impact to low risk but financially sound unrated fund types, such as pension funds and UCITs.

ISLA predicts that as borrowers start to review their lenders more effectively as a result of these rules, then unrated funds in the EU will be put at a disadvantage, and thus borrowers may look to source securities outside of Europe, thus diminishing liquidity, reducing transparency, and increasing trading costs through lesser price discovery. The new rules would deem much of current activity to be uneconomical whereby, the cost of capital far outweighs the benefit of the trade.

It is important to note that there are alternatives available to market participants to alleviate the impact of some of these changes, including the use of security interest collateral structures (Pledge) and central clearing (CCP) although both have limitations in the contexts of our markets.

It is also a concern of ISLA, that the rise in the average cost to do business by borrowers, will ultimately be paid for by long term investors, such as pensioners, through significantly reduced returns to pension funds for example, as a result of the changes to CRR & CRD. The reduction in the use of securities lending and

borrowing may also have further unintended macroeconomic effects. ISLA believe that this is contractionary to the agenda outlined by the Capital Markets Union, which is striving to make Europe more competitive across global markets.

ISLA would welcome the opportunity to discuss any of the concerns outlined in the above with EU legislative bodies in more detail.

<sup>1</sup> <https://www.fsb.org/wp-content/uploads/P070920-1.pdf>

<sup>2</sup> <https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2886865/870bbd5e-ae8f-4933-9f36-784c7183c7f4/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20SFTs.pdf?retry=1>

<sup>3</sup> [https://www.esma.europa.eu/sites/default/files/library/2016-1415\\_-\\_report\\_on\\_sfts\\_proccyclicality\\_and\\_leverage.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-1415_-_report_on_sfts_proccyclicality_and_leverage.pdf)