ISLA™

ISLA Response to Consultation Paper 16/22 – Implementation of Basel 3.1 Standards

March 2023

Consultation Paper (CP) 16/22 – Implementation of Basel 3.1 Standards

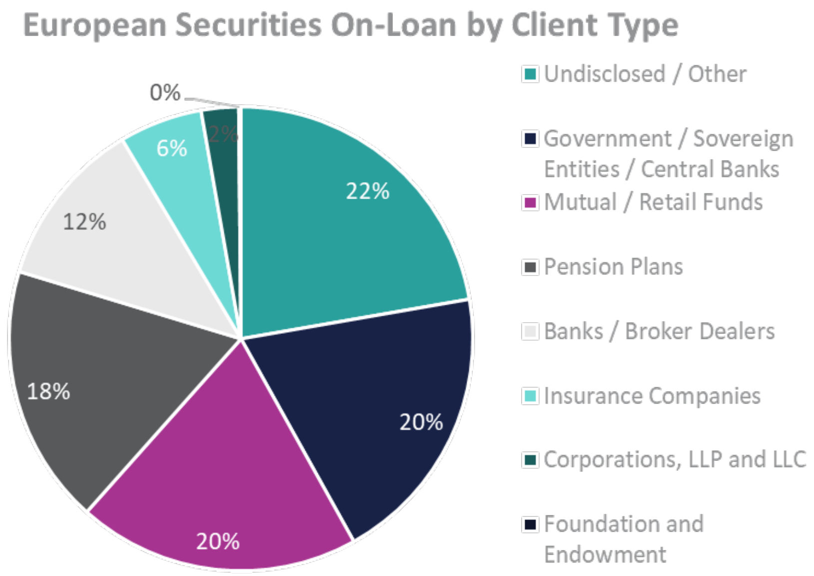
The **International Securities Lending Association (ISLA)** welcomes the opportunity to put forward the following considerations to the proposed rules regarding the implementation of Basel 3.1 standards and their impact to the securities finance business, which acts as an important source of funding for many financial institutions in the UK.

Question 8: Do you have any comments on the PRA's proposed approach for exposures to unrated corporates? Do you have any evidence – quantitative or qualitative – to support your comments, particularly in respect of the proposed 135% risk-weight for Non-IG exposures?

ISLA fully supports the introduction of a more risk sensitive approach to unrated institutions, that allows for exposures assessed by firms as 'Investment Grade' to be risk-weighted at 65%, whilst exposures assessed by firms as 'Non-Investment Grade' to be risk-weighted at 135% however, we would like to express concern that even with this preferential risk weight, the significant increase in capital costs under the new output floor may inevitably cause the activity of securities financing to become uneconomical, therefore policy makers may see a decline in the activity and thus liquidity across the capital market. This will ultimately drive up costs for low risk entities, such as pension and mutual funds.

The effect of this will be most noticeable in the case of low risk, financially sound but unrated institutions, which is where the majority of supply for SFTs in Europe derives from.

See below data provided to ISLA by **DataLend**.



As it stands, ISLA believes that the proposed treatment could in fact damage the UK's securities lending market.

Securities lending and borrowing is fundamental, but not limited to the following:

- The provision of secondary market liquidity of securities
- Increasing long-term investor returns on security portfolios
- Raising finance against long term investments
- Meeting prudential regulatory obligations such as the Liquidity Coverage Ratio and Net Stable Funding Ratio, helping to both manage and reduce systemic risk
- Sourcing and delivering collateral for margin requirements
- Facilitating market making activities of financial institutions, giving them ready access to securities that they may not be holding
- Facilitating settlement obligations and increasing operational efficiency
- Enabling short selling, which improves price discovery for institutional investors and improves market efficiency, mitigating price volatility

It is also deemed a low-risk activity as loaned securities are offset with collateral, where the value of the collateral typically exceeds that of the loaned securities and transactions are marked-to-market on a daily basis to ensure full collateralisation at all times. The majority of large institutional investors that lend securities, such as pension funds, UCITS, Central Banks and Sovereign Wealth Funds participate in securities lending, by lending assets for which they generate an additional portfolio income, benefitting investors, including retail.

The institutions that borrow securities from unrated institutions, are largely banks and broker dealers, who will need to assess the credit worthiness of their counterparties. In analysis performed by **S&P Global and Credit Benchmark** in 2022, they found that on average the credit quality of funds that lend securities in Europe, were mostly found to be of the highest credit quality. This analysis also showed, that after liaising with large IRB banks, they estimated that a typical risk weight for high quality mutual and pension funds is approximately 12.5%. Considering that the majority of funds do not have an external rating, but are mostly considered investment grade, the risk weights for these types of counterpart would increase on average from 12.5% to 65%.

It is important to note that ratings are typically used by issuers of securities to raise capital. Conversely, unrated funds, such as mutual and pension funds, do not have a need for an external rating, as they generally do not require access to capital and thus the costs and compliance burden of obtaining an external credit rating is unwarranted.

As a result, ISLA is concerned that many banks may reconsider their SFT business, or subsequently pass on the increased costs to their counterparties, who in turn, would likely find such activity uneconomic, unless there were exceptional circumstances. Therefore, SFT activity, and counterparties' access thereto, would be severely restricted. This would, in turn have serious implications for financial trading activities, market making, hedging and other financial risk-management activities that securities lending facilitates.

Combined, such factors would likely have a broader detrimental impact on investor returns, and financial markets would become less liquid and less efficient.

ISLA would like to note that the market is also exploring industry solutions to help alleviate the upcoming challenge:

- The use of the **Global Master Securities Lending Agreement 2018 (GMSLA) Security Interest (Pledge)** that allows borrowers of securities to transfer collateral to lenders by way of security interest rather than an absolute transfer of title. The Pledge GMSLA enables borrowers to benefit from the cost savings available from the better treatment for regulatory capital. The borrower retains a property interest in the collateral assets and is not exposed to the same risk of non-return of excess collateral by the lender. Therefore, its return does not carry such a risk weighting.

- Central Clearing for Securities Lending (CCP) is currently being explored however, as of today, there is no live product offering in this space, although ISLA have been made aware of offerings that are currently under development, with the intention for go live prior to January 2025. Utilising a CCP to clear securities lending transactions impacts credit and systemic risk, since the CCP is the legal counterparty to all transactions. This allows borrowing at a lower capital cost because CCP's typically have a consensus credit rating.

- Under the External Credit Risk Assessment Approach that utilises external ratings for regulatory purposes, the industry would also welcome a provider to offer ratings for funds. ISLA is aware of one market solution that is currently under development and also seeking FCA approval to become a registered ECAI.

ISLA would welcome the opportunity to provide more detailed reflections to the PRA if required.

About ISLA

ISLA is a leading non-profit industry association representing the common interests of securities lending and financing market participants across Europe, the Middle East and Africa. Its geographically diverse membership of over 190 firms includes a broad range of 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, as well as the periodical enforceability and security enforcement across global jurisdictions.

Through member working groups, industry guidance, consultations and first-class events, ISLA plays a pivotal role in the creation and promotion of market best practices and processes, thought leadership, standards for legal frameworks, and securities lending guides and related documents.

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