



Prudential Banking Rules: Explanatory Note



Contents

Overview of the Basel Framework	4
History	4
Aims & Objectives	5
Scope	5
Basel III	6
The Final Basel III Reforms	6
Key Terms & Definitions	6
Calculation of Capital Requirements under the Output Floor	7
Challenges for the Securities Finance Industry	8
Credit Risk RWAs under the Output Floor	8
Minimum Haircuts for Securities Financing Transactions	10
Addressing the Challenge	11

Overview of the Basel Framework

History

The Basel framework is a set of international standards developed by the Basel Committee on Banking Supervision (BCBS)¹, headquartered at the Bank for International Settlements (BIS)² to strengthen the supervision and risk management of banks.

The BCBS was originally created by the central bank governors of the group of ten (G10) nations including, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, the United Kingdom, and the United States of America, with Switzerland playing a minor role, in 1974.

As of 2023, the BCBS has 45 members³ from 28 jurisdictions, including 8 observers.

The Basel framework acts as a minimum set of standards which are intended to apply to internationally active banks. Member countries commit to implement and apply the standards in their jurisdictions under local law. The BCBS has revised the framework since the first issued guidance in 1975, to produce Basel I (the Basel Capital Accord), Basel II (a new capital framework), and more recently Basel III, as a response to the Global Financial Crisis in 2007-09.

The Basel Rules consist of 14 standards including:

- Scope & definitions
- Definition of capital
- Risk-based capital requirements
- Calculation of Risk Weighted Assets (RWA)
- Calculation of RWA for market risk
- Calculation of RWA for operational risk
- Leverage ratio (LR)
- Liquidity Coverage Ratio (LCR)
- Net Stable Funding Ratio (NSFR)
- Large exposures
- Margin requirements
- Supervisory review process
- Disclosure requirements
- Core Principles for effective banking supervision

¹ <https://www.bis.org/bcbs/>

² <https://www.bis.org/>

³ <https://www.bis.org/bcbs/membership.htm>

Aims & Objectives

The core purpose of the Basel framework is to ensure resilient banks and banking systems. The Basel framework is not binding regulation; it serves, however, as a common approach and a minimum standard with which to comply to reduce global divergence.

These rules are important because they determine the amount of capital banks need to have in relation to the levels of risk that they are exposed to. In the event of unexpected losses (for example through the default of counterparties or deterioration in their credit quality, a financial crash or global pandemic), the capital held, is expected to absorb any loss to ensure the ongoing viability of the bank.

As of 2023, the BCBS is currently focusing on creating standards for incorporating sustainability risk as well as a framework for the use of digital assets and digital infrastructures into the prudential framework.

Scope

Members of the BCBS agree to implement the Basel framework standards for their respective active international banks, within their jurisdiction under local law. The standards are essentially a minimum requirement; however, national members often decide to publish further enhanced rules within their jurisdiction.



Basel III

Following the Global Financial Crisis, the initial Basel III reforms were published in 2010. This began a period of implementation and transition for the banking industry as the new standards were translated into national law by each BCBS member and took effect in their jurisdictions. Further standards were published by the BCBS over subsequent years through an ongoing process of reform.

The Final Basel III Reforms

The BCBS determined that one key shortcoming of the pre-crisis bank capital framework, was the excessive variability in banks' RWAs, with capital requirements for similar assets differing between banks, which diminished the credibility of the framework.

In response, the Committee sought to improve the robustness and risk sensitivity of the standardised approaches to calculating RWAs and to reduce banks' reliance on internal models for calculating RWAs.

The Final Basel III Reforms⁴, which were published in 2017, took effect as international standards from 1 January 2023. The accompanying Output Floor for RWA is phased in over five years, through transitional arrangements until 1 January 2028. However, some jurisdictions have accelerated this timeline while others are planning their implementation on a later timeline.

Key Terms & Definitions

What are RWAs?

RWAs are an estimate of risk, which, along with the minimum risk-based capital ratios, determine the minimum level of regulatory capital a bank must maintain to deal with unexpected losses. Various types of risk are measured as RWAs, including market risk, credit risk, Credit Valuation Adjustment risk, and operational risk.

How do banks calculate credit risk RWAs?

Banks have two main methods of calculating credit risk and counterparty risk RWAs:

- Standardised Approach (SA): This relies on a uniform technique, which may make use of credit assessments made by recognised credit rating agencies.
- Internal Ratings Based Approach (IRB): This uses a firm's internal models, including inputs and assumptions derived from the firm's own data. Use of this approach must be approved by the national regulator in the relevant jurisdiction.

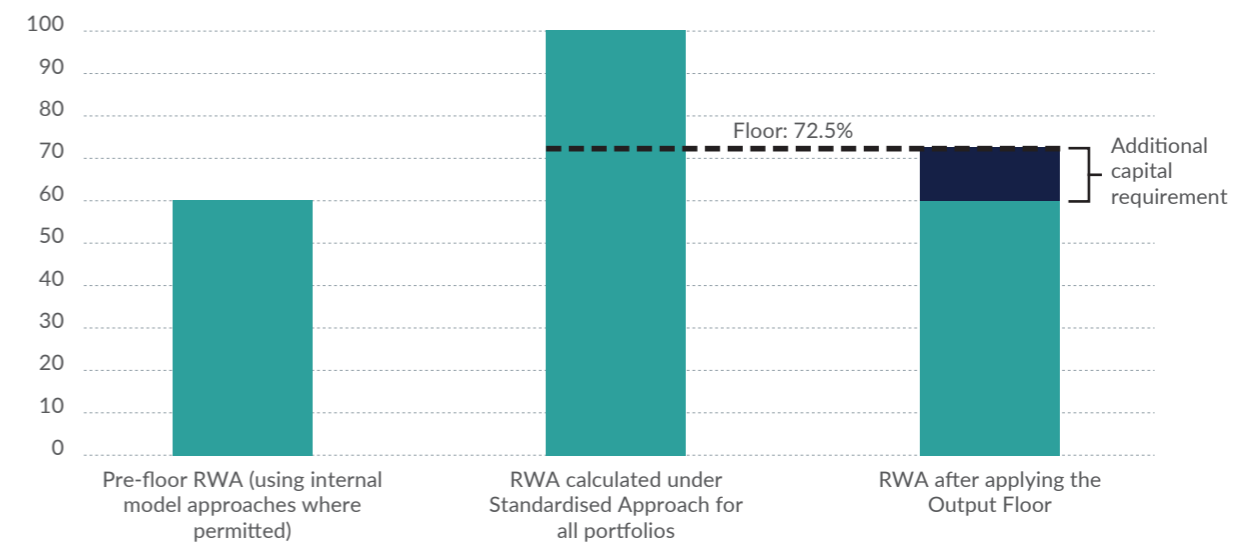
What is the Output Floor?

The Final Basel III reforms introduce an output floor, a measure that sets a lower limit (floor) on RWAs based on the revised standardised approaches in the framework. This will limit the benefit banks can obtain from their use of internal models to measure credit risk and market risk RWAs (since credit valuation adjustment risk and operational risk RWAs offer only standardised approaches under the Final reforms). The output floor aims to reduce unwarranted variability and increase the comparability of capital ratios of banks using internal models.

What other measures are in the Basel framework?

Risk-based capital ratios are supplemented by a number of other prudential constraints on banks. These include a leverage ratio (LR), Liquidity Coverage Ratio (LCR), and Net Stable Funding Ratio (NSFR).

⁴ <https://www.bis.org/press/p171207.htm>



Source: Deloitte⁵

Calculation of Capital Requirements under the Output Floor

The Final Basel III reforms introduce an additional step in the calculation of capital requirements for banks that use an internal model, who will now have to apply the following steps when calculating their RWA's:

1. Calculate the RWAs including the use of models the bank is permitted to use.
2. Calculate the RWAs using only the standardised approach.
3. Multiply the amount obtained with the standardised approach in Step 2 by 72.5%.
4. Compare the RWAs resulting from this calculation in Step 3 with the RWAs obtained with the calculation in Step 1. Whichever amount is higher is the one that is used to calculate the bank's various capital requirements.

⁵ <https://ukfinancialservicesinsights.deloitte.com/post/102gbh7/how-the-eu-could-implement-the-basel-iii-output-floor>

Challenges for the Securities Finance Industry

There are two forthcoming aspects of the Basel framework that could prove particularly challenging for the securities finance industry:

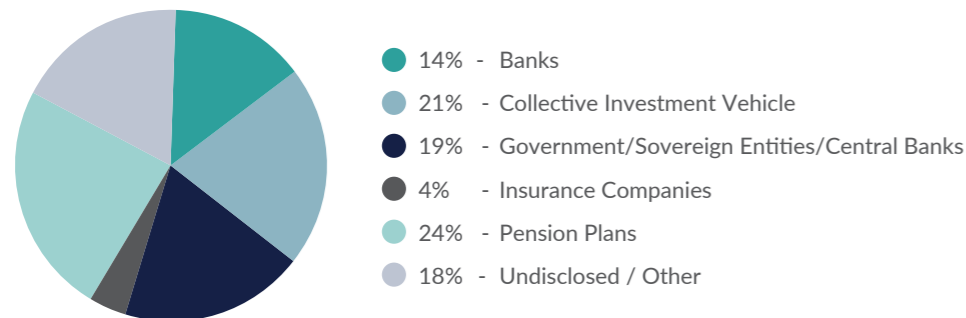
1. Credit risk RWAs under the Output Floor; and
2. Minimum haircuts for Securities Financing Transactions

Credit Risk RWAs under the Output Floor

The challenge affecting the securities finance industry is the potentially significant and disproportionate increase in the amount of capital banks need to hold under the Output Floor for credit risk in relation to their securities borrowing activity. In particular, the counterparty risk weights for most principal lenders under the standardised approach used in the Output Floor increase from low numbers today (typically around 10% under IRB) to 100%, alongside other increases in RWAs for banks at the same time.

- While the standardised approach applies by default, banks can obtain permission to use their internal models under the IRB approach.
- A large portion of banks, particularly larger institutions, have been using the IRB approach to assess the risk of counterparties that they are exposed to.
- Under the IRB approach, low-risk counterparties receive low counterparty risk weights (of around 10%, for example, for a low-risk fund).
- For banks with IRB permission, if the Output Floor is binding, then (72.5% of) the standardised approach RWAs applies.
- Under the standardised approach, counterparty risk weights are split into buckets set at 0%, 20%, 50%, 75%, 100% and 150%.
- Counterparties without external credit ratings default to a 100% risk weight. Pension funds, mutual/retail funds and UCITS, for example, are typically not rated by credit rating agencies and will therefore default to 100% risk weight. They fall under the 'corporate' bucket because they are not sovereigns or institutions (i.e., banks).
- The effect of the increased capital requirements under the new Output Floor will be most noticeable, therefore, in the case of low risk, financially sound but unrated funds, from where the majority of supply for SFTs derives (see pie chart below).
- ISLA believes that the proposed treatment of exposures to unrated low-risk counterparties could have an adverse impact on the global securities lending market.

The graph below shows data provided to ISLA by DataLend⁶ as of December 2022, illustrating securities on loan by client type. Approximately 45% of supply derives from unrated funds.



⁶ <https://datalend.com/>

Is there more than one Standardised Approach for credit risk?

In the BCBS framework, the treatment of 'corporate' exposure depends on whether the use of external credit ratings for regulatory capital purposes is permitted. The framework allows two approaches:

1. External Credit Risk Assessment Approach (ECRA):

This approach is for banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes. It applies to all their rated exposures to banks. Banks will apply CRE21.17 to CRE21.21 to determine which rating can be used and for which exposures. (For example, the United Kingdom and the European Union use this approach)

2. Standardised Credit Risk Assessment Approach (SCRA):

This approach is for all exposures of banks incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes. (For example, the United States use this approach)

The primary difference between the two approaches, is the risk weight applied to exposures to rated counterparties. ECRA allows a lower risk-weight bucket (Credit Quality Step, or CQS) to be assigned for counterparties with an investment-grade credit rating from a credit rating agency approved by the national regulator as an External Credit Assessment Institution (ECAI).

Under both the ECRA and the SCRA, unrated corporate exposures will be assigned a risk weight of 100%. Note that in SCRA jurisdictions only (i.e., the United States), unrated corporates which are identified as being 'investment grade' will be assigned a risk weight of 65%. In this context, an investment-grade corporate is one that has adequate capacity to meet its financial commitments in a timely manner and has securities outstanding on a recognised exchange.

- Some jurisdictions have offered a transitional approach for exposures to unrated entities, such as a 65% risk weight in the European Union.
- Other jurisdictions have offered a more risk-sensitive approach for unrated corporate exposures. For example, the United Kingdom (like Canada) has proposed splitting them into investment grade (65% risk weight) and non-investment grade (135% risk weight, or 150% in Canada).

⁷ https://www.bis.org/basel_framework/chapter/CRE/21.htm?inforce=20230101&published=20200327#paragraph_CRE_21_20230101_21_2

Minimum Haircuts for Securities Financing Transactions

There is a separate aspect of the Basel standards, minimum haircuts, that has generally not been implemented in national jurisdictions yet, but that may be in the future.

Under CRE56⁸, these minimum haircuts apply to:

- **Non-Centrally Cleared SFTs.** In which the financing (i.e., the lending of cash) against collateral other than government securities is provided to counterparties who are not supervised by a regulator that imposes prudential requirements consistent with international standards.
- **Collateral Upgrade Transactions with these same counterparties.** A collateral upgrade transaction is when a bank lends a security to its counterparty and the counterparty pledges a lower-quality security as collateral, thus allowing the counterparty to exchange a lower-quality security for a higher quality security.

SFTs with Central Banks are not subject to the minimum haircuts.

Cash-collateralised securities lending transactions are exempt from the minimum haircuts where securities are lent (to the bank) at:

- Long maturities and the lender of securities reinvests or employs the cash at the same or shorter maturity, therefore not giving rise to material maturity or liquidity mismatch.
- Short maturities, giving rise to liquidity risk, only if the lender of the securities reinvests the cash collateral into a reinvestment fund or account subject to regulations or regulatory guidance meeting the minimum standards for reinvestment of cash collateral by securities lenders set out in Section 3.1 of the Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos. For this purpose, banks may rely on representations by securities lenders that their reinvestment of cash collateral meets the minimum standards.

Residual maturity of collateral	Haircut level	
	Corporate and other issuers	Securitised products
≤ 1 year debt securities, and floating rate notes	0.5%	1%
> 1 year, ≤ 5 years debt securities	1.5%	4%
> 5 years, ≤ 10 years debt securities	3%	6%
> 10 years debt securities	4%	7%
Main index equities	6%	
Other assets within the scope of the framework	10%	

- The Financial Stability Board (FSB) stated in a report⁹ titled 'Transforming Shadow Banking into Resilient Market-based Finance' in 2015, 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".
- There is no distinction between specific transactions that are used for the purpose of financing and therefore increase leverage, and for transactions such as vanilla securities lending and borrowing that is mostly used to source a particular security, rather than for financing.
- It is important to note that as of May 2023, most jurisdictions have not incorporated the Minimum Haircuts for non-centrally cleared SFTs as part of their legislative proposals for Basel III.

⁸ https://www.bis.org/basel_framework/chapter/CRE/56.htm?inforce=20230101&published=20210701

⁹ <https://www.fsb.org/wp-content/uploads/P070920-1.pdf>

Addressing the Challenge

A mixture of alternative trading structures may prove effective for ensuring banks securities borrowing activity continues to attract a prudent but risk-sensitive capital requirement.

These may include:

- The use of the Global Master Securities Lending Agreement (GMSLA) 2018 Security Interest ('Pledge')¹⁰ that allows borrowers of securities to transfer collateral to lenders by way of security interest rather than an absolute transfer of title. The GMSLA Pledge potentially enables borrowers to benefit from the better treatment for regulatory capital, as 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, the borrower may be considered to not be taking any exposure to the principal lender and this potentially eliminates the RWAs and leverage exposure for the bank. ISLA would advise that members seek independent counsel on use of the GMSLA Pledge structures, as regulators may have differing interpretations depending on the jurisdiction.
- Utilising Qualifying Central Clearing for Securities Lending (QCCP) transforms the credit and systemic risk, since the CCP becomes the legal counterparty to cleared transactions. All QCCPs meet their own high standards of risk management and capitalisation and therefore banks' exposures to QCCPs benefit from a favourable prudential treatment. For credit risk, QCCPs attract a 2% counterparty risk weight.
- Under the ECRA that utilises external ratings for regulatory capital purposes, an external credit rating for low-risk funds provided by a registered ECAI that is nominated by a bank to its supervisor may result in more risk-sensitive outcomes for banks under the standardised approach, which is used in the Basel III Output Floor. For example, it may result in a 20% counterparty risk weight for low-risk principal lenders.
- Total Return Swaps (TRS) are being explored as a way to better manage banks exposure to credit risk more effectively. A shift from physical to synthetic lending can reduce RWAs and allow borrowers to manage their balance sheets more effectively.

¹⁰ <https://www.islaemea.org/gmsla-security-interest/gmsla-security-interest-agreements/>





Where are we

—
6th Floor
1 George Yard
London
EC3V 9DF

Contact us

—
support@islaemea.org
www.islaemea.org

Disclaimer

—
While we have made every attempt to ensure that the information contained in this paper has been obtained from reliable sources, the International Securities Lending Association (ISLA) is not responsible for any errors or omissions, or for the results obtained from the use of this information. All information in this survey is provided “as is”, with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, express or implied, including, but not limited to warranties of performance, merchantability and fitness for a particular purpose. Nothing herein shall to any extent substitute for the independent investigations and the sound technical and business judgment of the reader. In no event will ISLA, or its Board Members, employees or agents, be liable to you or anyone else for any decision made or action taken in reliance on the information in this Guide or for any consequential, special or similar damages, even if advised of the possibility of such damages.