



January 5, 2016

**Via Electronic Submission**

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

**Re: Consultative document: Haircut floors for non-centrally cleared securities financing transactions (5 November 2015) (the “Consultation Paper”)<sup>1</sup>**

Dear Sir or Madam:

Managed Funds Association (“**MFA**”)<sup>2</sup> welcomes the opportunity to provide comments on the Consultation Paper. MFA continues to support the work by the Financial Stability Board (“**FSB**”) and the Bank for International Settlements in identifying activities that could create systemic risks and introducing proposals to address those risks.

As a threshold point, we wish to emphasize that MFA continues to remain opposed to the use of numerical haircut floors as proposed by the FSB, and as incorporated by the Basel Committee on Banking Supervision (“**BCBS**”) in its proposed changes to the Basel rules text set out in the Consultation Paper. We note the FSB’s intention, as stated in its report “Strengthening Oversight and Regulation of Shadow Banking: Regulatory framework for haircuts on non-centrally cleared securities financing transactions” (14 October 2014) (the “**FSB Recommendations**”)<sup>3</sup> that the haircut floors serve as “backstops” that limit the build-up of excessive leverage while maintaining incentives for market participants to conduct their own analysis of the appropriate level of haircuts. MFA remains concerned, however, that such floors generally will be adopted as *de facto* benchmarks and applied mechanically, without careful and considered analysis of the correct haircut for a particular transaction.

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<sup>1</sup> Available at: <https://www.bis.org/press/p151105.htm>.

<sup>2</sup> MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals, and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

<sup>3</sup> Available at: [http://www.financialstabilityboard.org/wp-content/uploads/r\\_141013a.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_141013a.pdf), see Section 3.2 on page 8.

It is important that market participants are afforded the flexibility to tailor haircuts to address the particular risks of a transaction, including the credit quality of, and any liquidity risk in, the particular securities. MFA believes that it is at best unnecessary, and at worse counterproductive, to risk mitigation in securities financing markets to prescribe numerical floors by way of regulation. We are concerned that such an approach will discourage market participants from conducting their own diligence of the risks of securities financing transactions (“**SFTs**”) in respect of a particular security with a particular counterparty. In addition, the fact that the proposals do not take into account counterparty credit risk may lead to the unintended consequence that market participants are incentivized to enter into SFTs on securities of issuers with poor credit quality. This may have the perverse effect of creating more risk in the global financial markets.

As an alternative to the proposal, we respectfully urge the BCBS to consider following a similar approach to that proposed with respect to determining initial margin requirements under the European Market Infrastructure Regulation (“**EMIR**”) by the Joint Committee of the European Supervisory Authorities (the “**ESAs**”) in their draft technical standards (“**Draft RTS**”) on margin requirements with respect to non-centrally cleared derivative contracts. As explained more fully in the Appendix, we believe that such an approach would better achieve the stated goals of limiting the build-up of excessive leverage while maintaining incentives for market participants to conduct their own analysis of the appropriate level of haircuts.

To the extent the BCBS nonetheless decides to use numerical haircut floors, we have set out specific comments in response to the Consultation Paper in the Appendix, including suggested changes to the Consultation Paper’s proposed treatment of SFTs that do not meet the haircut floors.

We would be very happy to discuss our comments or any of the issues raised in the Consultation Paper with the BCBS. If the BCBS has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/Stuart J. Kaswell

Executive Vice President & Managing  
Director, General Counsel

## APPENDIX

### Responses to Questions in the Consultation Paper

#### **Q1. Are there any weaknesses or further improvements to the proposals that the Committee should consider?**

##### *The use of mandatory haircut floors*

MFA continues to oppose the use of mandatory haircut floors as proposed in the Consultation Paper. Our responses to the Consultation Paper discussed below are, therefore, only applicable to the extent that the BCBS decides to proceed with recommending such floors. We also note that MFA previously submitted a response to the FSB's "Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" (29 August 2013) (the "**Policy Framework**"),<sup>4</sup> which set out policy recommendations for addressing financial stability risks in relation to SFTs.

Despite the stated objective that the numerical floors are intended to create incentives for banks to set their haircuts above the floors, MFA believes that the floors set out in the proposals will be adopted as *de facto* benchmarks. Introducing *de facto* benchmarks likely will result in market participants relying upon the prescribed haircuts rather than undertaking their own due diligence and analysis of the risks associated with the collateral subject to the SFT. It is conceivable that such a scenario will, during times of market turbulence, create procyclical risk. Further, mandatory haircut floors may not match haircuts that would otherwise exist in the market especially given that the floors will not, by their nature, take account of risks that may arise over time and because we believe that it is unlikely that the market will adopt haircuts that go beyond prescribed floors.

Finally, MFA continues to question whether the absence of mandatory haircut floors increased procyclical risk during the financial crisis.

##### *Incentives for conducting internal risk management analysis*

MFA strongly encourages the BCBS to include in its amendments to the Basel rules text mechanisms that will incentivize market participants to conduct their own risk management analysis with respect to setting haircuts for SFTs. Such incentives are particularly important given the risk, as noted above, that numerical haircut floors will be generally adopted and mechanically applied to all in-scope SFTs.

We suggest that the BCBS consider following a similar approach to that proposed with respect to determining initial margin requirements in the Draft RTS under EMIR<sup>5</sup> with respect to non-centrally cleared derivative contracts.<sup>6</sup> The Draft RTS provide that the

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<sup>4</sup> Available at: [http://www.financialstabilityboard.org/wp-content/uploads/r\\_130829b.pdf?page\\_moved=1](http://www.financialstabilityboard.org/wp-content/uploads/r_130829b.pdf?page_moved=1). The MFA's response to the Policy Framework is available at: [http://www.financialstabilityboard.org/wp-content/uploads/c\\_131220s.pdf](http://www.financialstabilityboard.org/wp-content/uploads/c_131220s.pdf).

<sup>5</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN>

<sup>6</sup> Second Consultation Paper: Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, available at:

amount of initial margin which a counterparty is required to collect in respect of a transaction may be calculated by reference to either (i) a bespoke initial margin model, or (ii) a standardized method. MFA considers that if a similar approach were employed for non-centrally cleared SFTs (*i.e.*, such that counterparties are permitted to use either a bespoke risk model or the standardized haircut floors), such approach would encourage market participants to develop their own quantitative risk models under the supervision of their relevant supervisory authorities, rather than applying the prescribed haircut floors without further analysis. We believe that this approach will promote the position encouraged by the FSB in the FSB Recommendations, that market participants should “determine their own, more granular risk-based haircut schedules, in accordance with the methodology standards as set out [in the FSB Recommendations], and to set higher haircuts than any regulatory numerical haircut floors where prudent.”<sup>7</sup>

Further, given that derivatives can achieve a similar economic objective to SFTs, it would seem logical to benefit from the work done by regulators in determining methodologies for haircuts on collateral used in the derivatives markets. In particular, as noted above, we would suggest the adoption of the approach taken in the Draft RTS. The Policy Framework itself notes that the FSB planned to co-ordinate closely with the BCBS-IOSCO monitoring group on margin requirements for non-centrally cleared derivatives. We believe that following the Draft RTS, which have been developed in light of the BCBS-IOSCO principles in respect of the use of margin for non-centrally cleared derivatives,<sup>8</sup> will avoid regulatory arbitrage and facilitate a smoother implementation of the proposals as market participants can apply consistent haircuts across SFTs and collateral for non-centrally cleared derivatives.

*Treatment of in-scope SFTs which do not meet the haircut floors*

Section 143(vii) of the BCBS’s proposed changes to the Basel rules text states that “[i]n-scope SFTs which do not meet the haircut floors must be treated as unsecured loans to the counterparties.” MFA is concerned that treating the entire exposure of an SFT as unsecured for capital purposes if the minimum haircut is not charged is overly punitive and will further incentivize bank counterparties to mechanically apply the prescribed minimum haircut floor. We therefore strongly encourage the BCBS to provide that a failure to comply with haircut floors will reduce the value of the collateral in proportion to the difference between the haircut floor and the haircut applied by the banks, as suggested by the FSB in “Option 2” of its “Optional treatments to induce use of haircut floors” in the FSB Recommendations.<sup>9</sup> Under such approach, only that portion of the unsecured exposure in excess of the haircut floor would attract adverse capital charge consequences. As the FSB notes in the FSB Recommendations, this approach would maintain incentives for banks to lend on a secured basis.

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<https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf>

<sup>7</sup> See section 3, page 3 of the FSB Recommendations.

<sup>8</sup> <http://www.bis.org/bcbs/publ/d317.pdf>

<sup>9</sup> See page 15 of the FSB Recommendations.

Additional Clarifications

MFA also respectfully requests that BCBS provide clarification on the matters set out below.

- i. The haircuts set out in the Consultation Paper include a haircut floor of 6% for “main index equities.” MFA respectfully requests that the BCBS clarify the meaning of this term. In particular, we note that the risk and liquidity profile of equities in the key indices in one country may differ from those in the key indices in another country (*e.g.*, some constituents of the Russell 1000 Index in the U.S. may present smaller risks than securities in an emerging market’s main index), and a 6% haircut floor may not be appropriate in all cases.
- ii. MFA requests that BCBS clarify which haircut floors should apply to convertible bonds or other equity-linked instruments. Should such instruments be considered “debt securities”, “main index equities”, or “other assets within the scope of the framework”?

**Q2. Are there any specific implementation challenges with the proposals?**

MFA considers that any phase-in period needs to reflect the numerous documentation and operational challenges that will result from the changes proposed in the Consultation Paper. It is also important to keep in mind that market participants already face significant new regulation in the global financial markets which pose challenges for implementation within prescribed deadlines. For example, the Draft RTS will be phased in from September 2016 to September 2020 with significant operational and documentation challenges arising both before and during this implementation period.