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Clive Briault
Director of Prudential Standards
The Financial Services Authority
25 The North Colonnade
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29 May 2002

Re: Large Exposures Regulation of Securities Lending and Repo Transactions under Basel II

Dear Mr Briault,

The International Swaps and Derivatives Association ("ISDA"), London Investment Banking Association ("LIBA") and The Bond Market Association ("TBMA") (collectively "we" or the "Associations") are writing in respect of a major potential change to Financial Services Authority (FSA)'s regulated firms' Large Exposures capital requirements. This change will arise as a result of the proposals under the new Basel Accord which impose a "haircut" on the value of collateral in respect of securities lending and repo transactions. As you are aware the application of haircuts to collateral in such transactions, which are almost exclusively trading book in nature in the European Union ("EU"), results in the nominal size of the net exposure on the transaction being substantially increased (due to the decrease in the value of the collateral being applied against the exposure). As a number of members of the Associations have already raised with you, our concern is that this nominal value is used to calculate not only the counterparty risk capital requirement in the trading book, but also the total exposure to the relevant counterparty used for calculating the institution's large exposure capital requirement ("LER") specified in the Bank Consolidation Directive ("BCD") (2000/12/EC) and the Capital Adequacy Directive ("CAD") (93/6/EEC) of the EU. We do not believe that there is at present any intention on behalf of the European Commission or the Member States to review and revise the EU Large Exposures regime in its own right, and it seems to us that these changes in nominal exposure would be an unintended consequence of the proposed haircuts under the new Basel Accord.

It is not the purpose of this letter to comment on whether the collateral haircuts are appropriate, as this has been addressed by the Associations in detail elsewhere. Rather our point here is that assuming haircutting the value of collateral is appropriate in the sphere of credit risk, the resulting concentration risk charges produce a serious anomaly within the existing large exposures risk methodology, resulting in prohibitive large exposure charges, particularly in connection with intra-group securities lending and repo transactions. This

anomaly arises from the superequivalent implementation by the FSA of the Large Exposures provisions of the BCD and CAD. We believe that the FSA should remove the rules which give rise to this problem whilst remaining in conformity with the EU directives.

CURRENT SECURITIES LENDING ARRANGEMENTS

Whilst the increase in the Large Exposures charge which results from the introduction of collateral haircuts impacts all of the securities lending or repo transactions which a firm may enter into, the most detrimental impact arises as a result of intra-group securities lending exposures. For many financial institutions intragroup securities lending transactions are a significant part of their overall financing arrangements and have considerable advantages in terms of risk reduction, in particular through the reduction of operational risk. We believe it would be counterproductive if the introduction of these collateral haircuts were to create disincentives to the use of such risk-reducing structures within affiliated financial services groups because of the FSA's implementation of the EU Large Exposures regime. Given that the FSA is well aware that firms use securities lending and repo transactions for a variety of reasons including enhancing liquidity, as a source of funding and as a balance sheet management tool, we believe that the FSA will share our concerns regarding the potential adverse impact to the structure and efficiency of these markets.

In the attached appendix we have set out a diagram showing how intragroup repo and securities lending arrangements are typically conducted today. As an example, a financial group may have US customers whose relationship is with a US group company, but who wish to have access to UK equities that are held by (or accessed by) a related UK group company. In this scenario a securities lending arrangement may be entered into between the related UK and US group companies. This enables the client to enter into a single relationship with one financial institution and reduces the risks of every party in the transaction chain. Examples of the particular risks that are reduced are operational risk, as a result of fewer and more direct trade settlement mechanisms and reduced legal and documentation risk resulting from fewer business agreements and netting enforceability determinations. Furthermore there are clear client benefits to this structure. Most importantly, the client has one counterparty incorporated and authorised in its own (or a familiar) jurisdiction rather than several counterparties spread across the globe. As a result, it too will benefit from a reduction in legal and operational risk.

Intragroup securities lending and repo arrangements can involve very large sums in terms of gross open transaction values. The effect of collateral haircuts on these gross transaction values can lead to significant increases in nominal exposures and hence in the LER. The magnitude of this increase in LER should not be underestimated by the regulators. We believe it will account for a substantial part of the increase in overall capital requirements for some financial institutions resulting from the application of the new Basel proposals to trading book exposures. A number of firms have previously submitted data on this to FSA and would be willing to share data bilaterally with regulators on this issue in the future.

The proposed collateral haircuts will act as a significant disincentive for firms to use intragroup transactions in their business. To avoid such an impact firms may structure their businesses as shown in the second diagram in the attached appendix. This would lead to increased operational, settlement and legal risk for the firm and the client.

We are concerned about this prospect because we do not believe that an increase in these large exposure charges, which will result from the introduction of collateral haircuts, is intended by the FSA or by the EU. Furthermore we believe that there are options available to the FSA which are consistent with the existing EU directives and which would largely avoid the problem.

FSA IMPLEMENTATION OF EU DIRECTIVES ON LARGE EXPOSURES

EU directive provisions on Large Exposures specify a number of circumstances in which a regulator has the discretion to reduce or exempt an exposure for the purposes of the large exposure rules, not all of which have been incorporated in current FSA rules. We believe there is a need for FSA to revisit the current large exposure regime and the available exemptions to address the prohibitive large exposure charges that would result for FSA-regulated firms from the direct transposition of the Basel II proposals into EU legislation, without corresponding amendments being made to the FSA's own rules.

There are allowable exemptions under the BCD and, by extension, the CAD, which could cover the type of securities lending and repo arrangements outlined above, and which would obviate to a large extent the penal concentration risk charges which would be generated by exposures subject to the collateral haircut regime. These exemptions are available under current FSA rules for third party exposures, but are generally not available (or are available only subject to certain conditions) for exposures to connected counterparties in the Interim Prudential Sourcebook for Banks ("IPRU (Banks)") and the Interim Prudential Sourcebook for Investment Firms ("IPRU (INV)").

The proposed rules set out in CP97¹ also do not serve to address the problems faced by firms. Exemptions given for connected counterparties (PRCR 5.9) apply to exposures incurred under a banking book hard limits regime. It is not clear whether the exemptions also apply to the calculation of charges under a trading book soft limits regime. The restrictions on the exemptions in PRCR 5.9 in relation to the hard limits regime are heavily superequivalent to the BCD. Even if the exemptions extend to the calculation of charges (under a soft limits regime) the restrictions on the types of eligible transactions applicable, as set out in PRCR 5.9.2(7) and the 50% limit on the exposures which may be exempted per PRCR 5.9.2 (2), effectively limit their usefulness.

By contrast, Article 49(7)(i) of the BCD allows member states to "fully or partially exempt ... asset items constituting claims on and other exposures to credit institutions, with a maturity of one year or less but not constituting such institutions' own funds." This is extended in CAD (Annex VI paragraph 7) to exposures to investment firms. The application of this exemption to intragroup securities lending and repo transactions could be utilised by the FSA, and would do much to minimise the increases in LER caused by the imposition of collateral haircuts under the proposed Basel Accord.

Additionally, Article 49(9) of the BCD provides that Member States may apply a weighting of 20% for large exposure purposes to asset items constituting claims on and other exposures to credit institutions with a maturity of more than one but not more than three years, and a weighting of 50% to traded debt securities issued by credit institutions with a maturity of more than three years. Article 49(10) provides that, by way of derogation from paragraphs 7(i) and 9, Member States may apply a weighting of 20% to asset items constituting claims on and other exposures to credit institutions, regardless of their maturity. These exemptions are available under current FSA rules for third party exposures but are available only subject to certain conditions for connected counterparties. This restriction has no basis on the face of Articles 49(9) and (10). We are not clear why this approach has been taken. The application of the concessions above to connected counterparties would do much to address the potential detrimental effect of collateral haircuts on LER charges if made available in conjunction with the application of the exemption provided for under Article 49 (7)(i).

We have also considered the operation of the LER regime in other EU member states. In general, we have found that the issue would not arise because of the lack of superequivalence

¹ Consultation Paper 97 on the FSA Integrated Prudential Sourcebook.

in implementing the BCD and CAD in this regard. It seems that treating exposures to group authorised institutions more harshly than exposures to non-group authorised institutions is a peculiarity of the FSA's Large Exposures regime.

CONCLUSION

None of the regulatory authorities have argued that the present Large Exposure regime is deficient or that it requires a substantial increase in regulatory capital allocation. We also note that one of the key drivers for the capital review was the need to give greater regulatory recognition to the beneficial effects of credit risk mitigation ("CRM") techniques, including collateral, and that it appears to us therefore anomalous that measures introduced to reduce the regulatory capital for credit risk due to CRM could have the effect of increasing the capital burden in the trading book environment.

The consequences for the securities industry in general and for the London markets in particular of the imposition of the proposed regime in its current form seem to us to be very serious. Given the size of the nominal values traded in the securities lending and repo markets, it would be very difficult to continue the business as it is currently structured. Potential solutions adopted by market participants could involve the restructuring of transaction flows in a way that increases settlement risk for all parties in order to reduce the regulatory capital requirements, and would limit the liquidity and efficiency of the securities financing markets.

In a context where the size and structure of economic exposures in the Trading Book remains constant and the authorities are not arguing the present Large Exposure regime is deficient, we believe that it would be inappropriate for a major increase in capital charges under the Large Exposure provisions to be permitted without a direct regulatory justification or more developed dialogue.

We believe that the FSA could amend its own rules so as to avoid this problem under the existing EU directives.

We would welcome the opportunity to discuss this with you.

Yours sincerely,



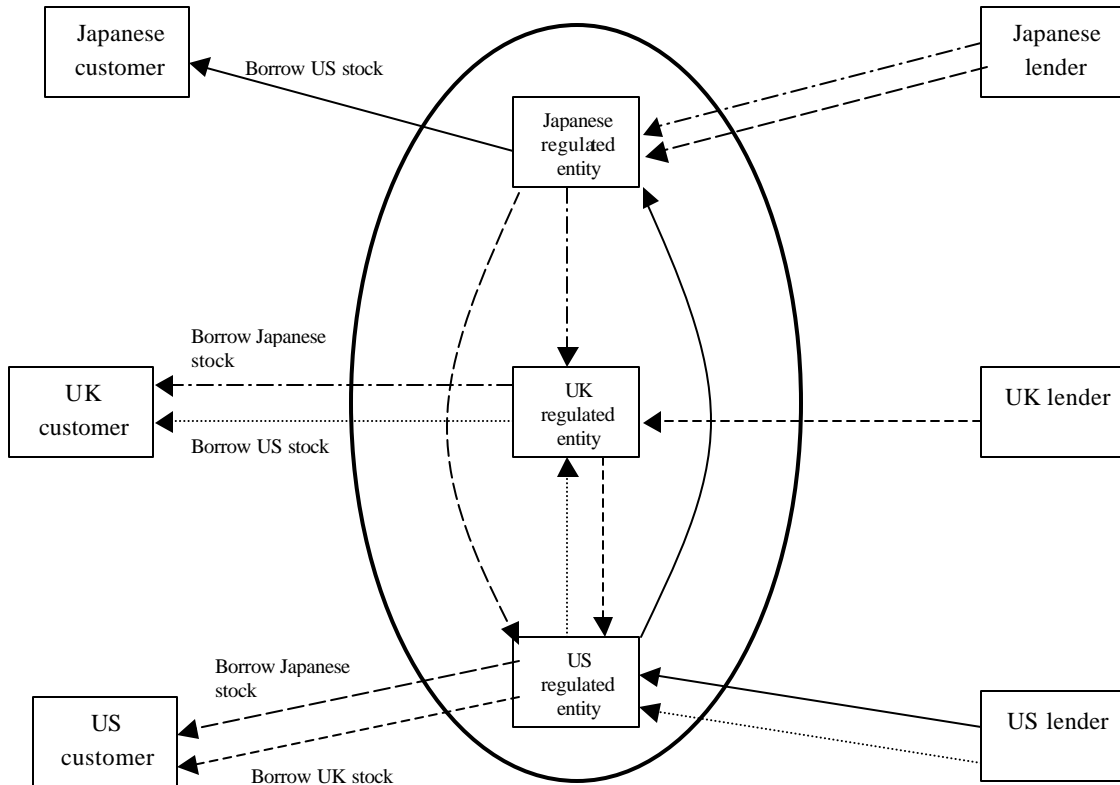
Emmanuelle Sebtou
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Katharine Seal
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Marco Angheben
TBMA

Appendix

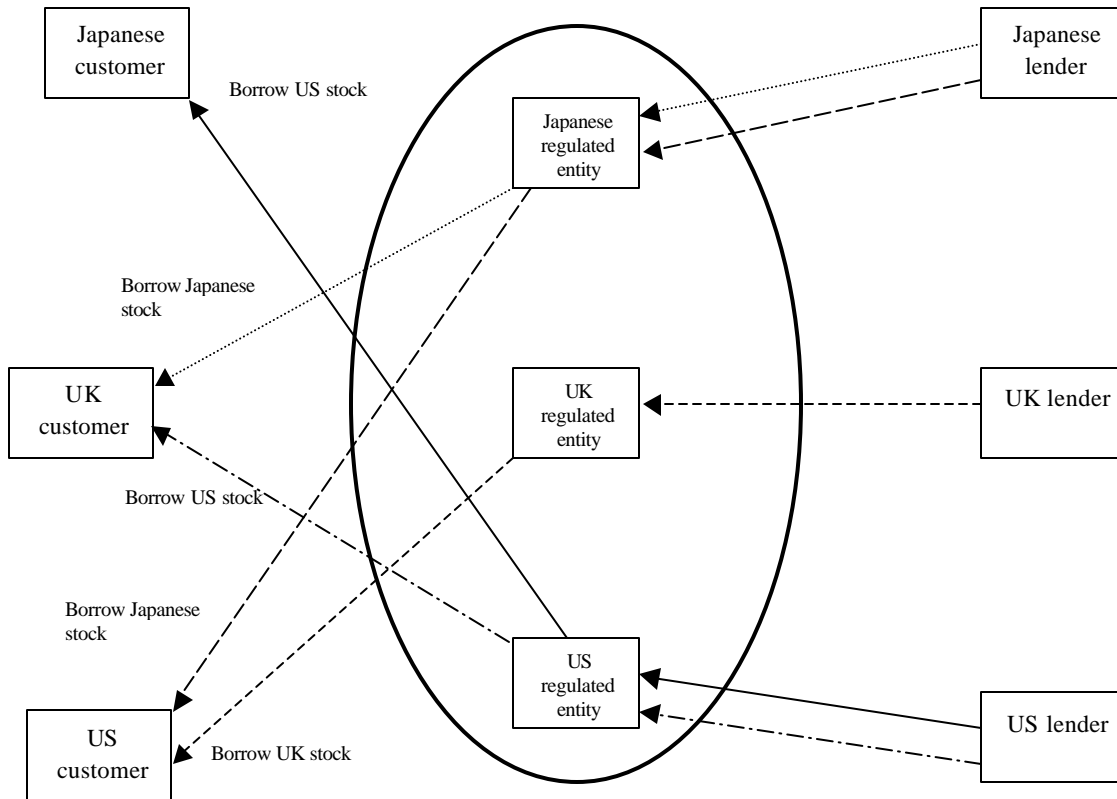
CURRENT STRUCTURE OF REPO/SECURITIES FINANCING BUSINESS



Customer deals with a single group entity:

Single netting agreement required – customers want this.
Customer credit risk to group decreases
Group credit risk to customer decreases
Operational and settlement risk decreases

REVISED STRUCTURE OF REPO/SECURITIES FINANCING BUSINESS IN LIGHT OF THE EFFECT OF HAIRCUTS ON LER



Customer deals with multiple group entities:

- Multiple netting agreements required – customers don't want this.
- Customer credit risk to group increases
- Group credit risk to customer increases
- Operational and settlement risk increases