

# Impact of pending Basel rules on the buy-side

16 March 2022



# Overview

- The pending Basel rules limit the ability of banks to apply internal rating models for Risk Weighted Asset (RWA) purposes which determine a bank's capital requirements
- When banks transact with pension, mutual and sovereign wealth funds (SWF), they need to assign a counterparty risk weight in compliance with the Basel rules
- The impact of the new Basel regulations will increase risk weights and therefore costs for funds in Basel jurisdictions resulting in a reduction in market liquidity. Some regulators appear to be unaware of these significant unintended consequences.
- Risk weights are different between Basel and non-Basel jurisdictions (US) highlighting that the cost of doing business can differ by jurisdiction. The new Basel rules may cause the US to reassess risk weights for funds.

# Risk Weights Summary

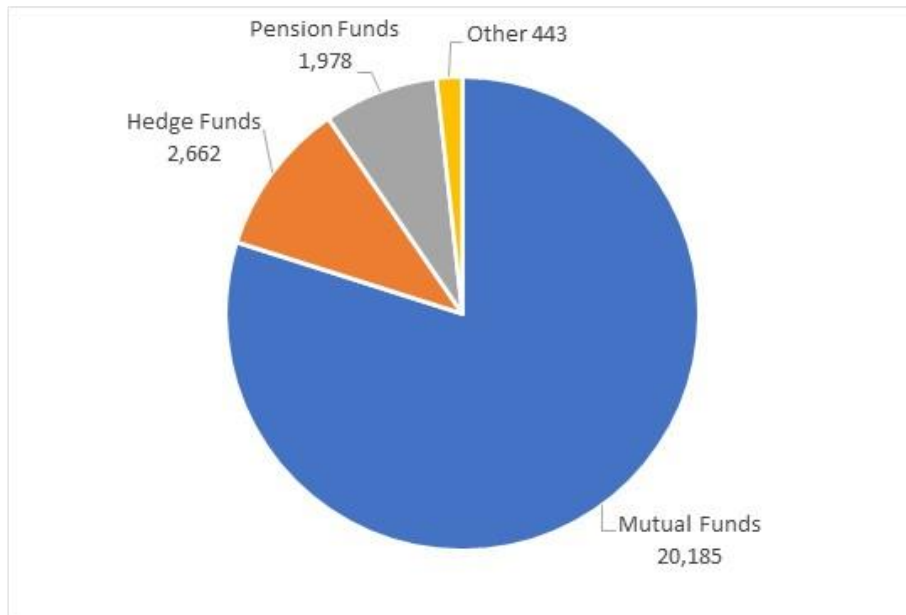
	Basel / US Banks (Sovereign)	Basel Regulated Banks (Funds)			US Regulated Banks (Funds)	
Regulatory RWA Categories	Standardised	Standardised	IRB	Unrated Proposal (EU)	Current	Removal of SLR?
AAA to AA-	0%	20%	c. 10%	65%	100%	65%
A+ to A-	20%	50%	c.15%	65%	100%	65%
BBB+ to BBB-	50%	75%		65%	100%	65%
BB+ to BB-	100%	100%		100%	100%	100%
B+ to B-	100%	150%		100%	100%	100%
CCC+	150%	150%		100%	100%	100%
NR	100%	100%				

**Standardised method** - calculating capital requirements supported by credit assessments made by external credit assessment institutions / regulatory guidelines

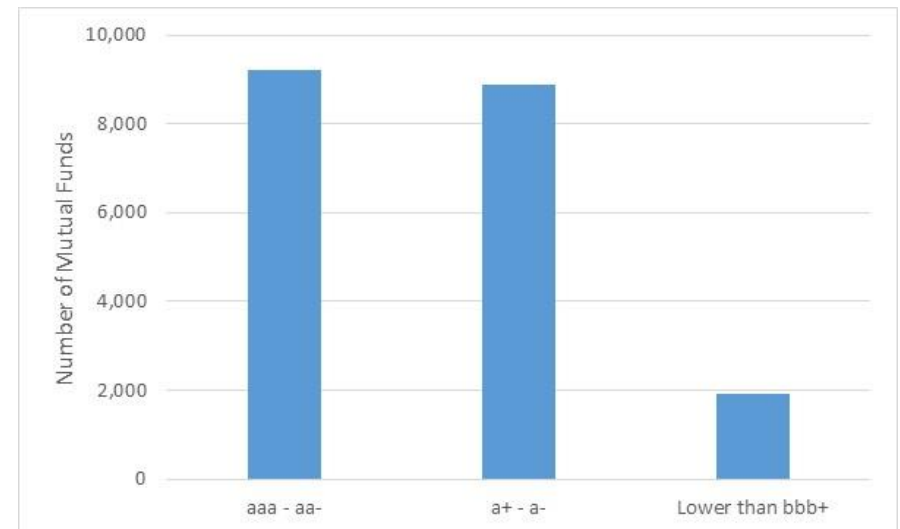
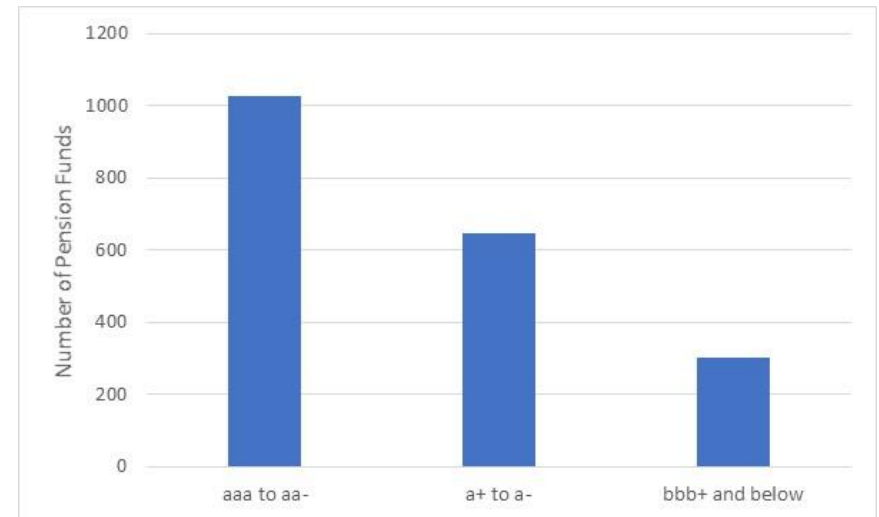
**Internal ratings-based approach (IRB)** – calculating capital using bank’s own estimated risk parameters and models

**Securities Listing Requirement (SLR)** – An obligor can be considered to be investment grade only if it is listed on a recognised exchange

# Less than 0.2% of mutual funds and 0.7% of pension funds are rated



- Credit Benchmark has consensus ratings on over 25,000 funds derived from regulated IRB models
- High-quality mutual and pension funds risk weight will jump from c.12.5% to 65% in EU as most are unrated

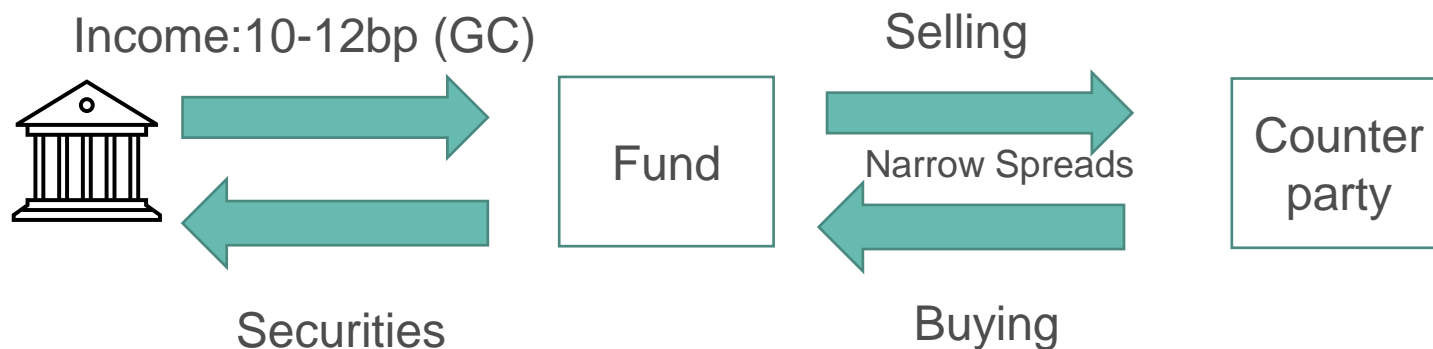


# Key challenges for the funds sector – Basel jurisdictions

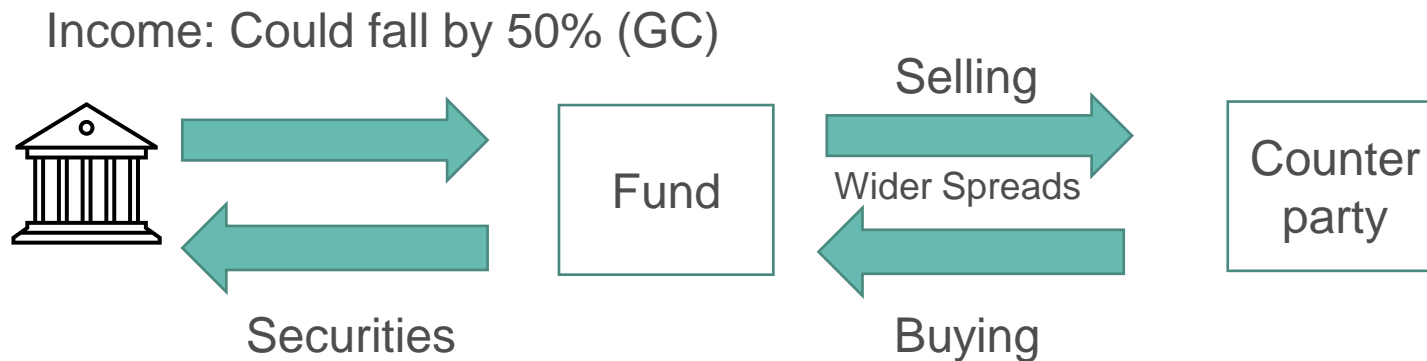
- Mutual and pension funds will see a significant jump in risk weight allocation by banks from around 12.5% to 65% - a fivefold increase in capital
- Some SWFs may be able to maintain low / 0% risk weight if OECD and can demonstrate that SWF is an arm of government. Arms-length funds are less likely to be signed off as sovereign by regulator.
- The 5-fold increase in capital will reduce securities financing activity which will negatively impact market liquidity and widen bid offer spreads
- Wider spreads for large caps will increase the cost for funds to buy and sell securities. These extra costs are likely to be passed on to consumers, thereby impacting savers long run returns.
  - CFA data suggests effective spreads are 4bp for large caps & 10bp for small caps (Europe)

# Key challenges for the funds sector – Basel jurisdictions

**12.5% Risk Weight helps maintain lower bid offer spreads**



**65% Risk Weight will drive spreads wider as securities lending falls**



# Key challenges & opportunities for the funds sector - US

- Despite funds in the US being high quality investment grade, they do not meet the securities listing requirement for the 65% risk weight and hence have a 100% risk weight. The EU in Oct 21 has removed the securities listing requirement for investment grade determination
- Research by Credit Benchmark with the BPI demonstrates that the consistency in risk weights does not vary whether the entity is publicly traded or privately held, indicating that the SLR does not improve credit risk management <https://bpi.com/consistency-in-risk-weights-for-corporate-exposures-under-the-standardized-approach/>
- Funds in the US have an opportunity to bring down risk weights from 100% to 65% through removal of SLR, thereby reducing costs and improving market liquidity. Funds are likely to have a much greater chance of influencing the Federal Reserve than the banks

# Regulatory discussions to date



South African Reserve Bank



# Summary

- The new Basel rules will have significant consequences for the buy-side due to a jump in risk weights applied by banks from c. 12.5% to 65%
- This increase in costs is likely to severely curtail securities financing activity, thereby widening bid offer spreads for large caps. This increase in costs is likely to be passed on to consumers
- Conversely these rules may provide impetus for US regulators to reduce risk weights for funds from 100% to 65% given that the majority of funds are high credit quality and do not pose risks to the financial system
- Credit Benchmark has been exploring solutions to help mitigate these issues with global regulators including potentially submitting an ECAI application for Basel jurisdictions reducing risk weights down to 20%, and working with key stakeholders in the US looking at removing the SLR which would reduce risk weights down to 65%



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