Policy Spotlight

BlackRock

BlackRock's take on the Basel III Endgame and G-SIB Surcharge Proposals

Introduction

On July 27, 2023, the Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (together, the "Agencies") jointly published a Notice of Proposed Rulemaking for modifications to the bank capital rules—commonly referred to as the Basel III Endgame proposal (the "Basel Proposal") and G-SIB Surcharge proposal (the "GSIB Surcharge Proposal"). These proposals represent substantial changes to the existing U.S. capital framework for banking organizations and U.S. global systemically important bank holding companies ("U.S. GSIBs").

BlackRock is supportive of efforts to help ensure that risk-based capital requirements for large banking organizations are appropriately calibrated and sufficiently comprehensive to adequately address the risk exposures banking organizations face without imposing excessive costs on investors or creating unintended consequences for other sectors of the financial system. As a fiduciary to its clients, BlackRock shares the Agencies' goal of protecting the interests of investors by facilitating the resiliency and stability of the U.S. banking system that our clients rely upon to meet their financial goals. Banks play a critically important role in financial markets as intermediaries, liquidity providers and lenders of cash and securities. As asset managers, we rely on banking organizations to facilitate access to the markets in order to invest and hedge risk on behalf of our clients. However, we are concerned that the Basel Proposal and GSIB Surcharge Proposal, as drafted, would have unintended consequences that could discourage banking organizations' participation in markets, harming liquidity and reducing investors' access to important financial products used to manage risk. These costs are ultimately borne by end-investors, our clients, including pension plans and individual investors saving for a college education, buying a home, and retirement.

BlackRock submitted a comment letter that addressed various aspects of each of the proposed rulemakings and offered recommendations to help achieve the goals of the Agencies, while avoiding disruptive unintended consequences (available here).

A summary of BlackRock's views on certain key provisions of the proposed rules follows.

Summary of BLK's views

1. **The Basel Proposal should extend the 65% risk weighting category to include certain investment funds and institutional investors.**
2. **The Agencies should not adopt minimum haircut floor requirements at this time. However, should the Agencies choose to proceed, we recommend several modifications to the proposed requirement to avoid possible negative outcomes.**
3. **The Agencies should modify the risk-weight treatment of closed-end preferred stock to align its risk weighting with similarly situated securities.**
4. **The GSIB Surcharge Proposal is an opportunity to holistically improve the current treatment of ETFs to more accurately reflect the credit quality of their underlying assets.**
5. **We believe the GSIB Surcharge should not include agency model cleared OTC derivatives in the systemic indicators of the calculation.**

All source information can be found in the Endnotes section. The opinions expressed are as of February 2024 and may change as subsequent conditions vary.

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1 The Basel Proposal should extend the 65% risk weighting category to include certain investment funds and institutional investors.

- Currently, U.S. capital rules generally require a banking organization to assign a risk weighting of 100% to its corporate exposures under the standardized approach to credit risk, with no differentiation between such exposures based on the creditworthiness of the obligor.
- The Basel Proposal takes a more nuanced approach to better differentiate the credit quality of corporate obligors, reducing the risk weighting for certain investment grade corporate exposures from 100% to 65%, but requires that such corporate obligors have a publicly traded security outstanding or are controlled by a company that has a publicly traded security outstanding.[1]
- The publicly traded securities requirement would prevent otherwise creditworthy non-ETF mutual funds, collective investment funds, pensions funds, insurance companies, private funds, and other institutional investors from receiving a 65% risk-weighting (which may, in fact, be more commensurate with the risk such an exposure would pose to a banking organization than the default 100% risk-weighting).
- BlackRock recommends extending the availability of the 65% risk weighting category beyond what was proposed to include investment grade exposures to certain investment funds (i.e., non-ETF mutual funds, business development companies, collective investment funds, private funds) and institutional investors (e.g., pension funds and insurance companies).
- We believe that many of the investment funds and institutional investors we recommend be eligible for the 65% risk-weighting are highly creditworthy and would rationally be classified as "investment grade" under any reasonable credit-risk assessment model. Furthermore, they are subject to statutory or regulatory transparency, and other market standard mechanisms, that provide banking organizations with levels of transparency comparable to that of entities with publicly traded securities.
- If the Agencies do not make the conforming modification we recommend, we believe these entities would likely face higher costs to engage in services relative to less punitively risk weighted, though similarly creditworthy, entities.
- BlackRock believes that its recommended approach is consistent with the Agencies' stated rationale for the proposed publicly traded securities requirement and furthers its objective of applying tailored risk weights to foster the safety and soundness of banking organizations.

2 The Agencies should not adopt minimum haircut floor requirements at this time. However, should the Agencies choose to proceed, we recommend several modifications to the proposed requirement to avoid possible negative outcomes.

- The Basel Proposal would impose minimum haircut floors on banking organizations for some non-centrally cleared securities financing transactions ("SFTs"), and netting sets of SFTs, with "unregulated financial institutions."
- We believe that the proposed changes would have a number of negative effects that could ultimately result in investors facing increased costs and more limited access to the banking organization services and products that they rely on to effectively manage risk and meet their investment objectives.
- BlackRock recommends that the Agencies decline to adopt the proposed minimum haircut floors for SFTs until more insight into the potential effects of the requirement are known and analyzed.
- Should the Agencies determine to move forward with requiring minimum haircut floors, BlackRock recommends they include several modifications to mitigate some of the potential negative effects. To that end, we recommend:
  - Modifying the definition of "unregulated financial institution" to apply only to unregulated financial institutions that have significant leverage and engage in maturity transformation.
  - Not expanding the definition of "in-scope transactions" to include sovereign securities.
  - Broadening the cash reinvestment exemption to a wider set of transactions in liquid assets.
  - Clarifying that collective investment funds ("CIFs") and investment funds holding ERISA plan assets (or their non-U.S. equivalents) are excluded from the definition of "unregulated financial institution."

[1] Risk-weighted assets are employed to establish the requisite minimum capital that a bank needs to maintain in relation to the risk associated with its lending activities and other assets. This measure aims to mitigate the risk of insolvency and safeguard depositors.

– Explicitly stating that the exclusion from the definition of "unregulated financial institution" applies to any unregulated financial institution that holds qualifying ERISA plan assets or otherwise serves as the investment vehicle for a pension fund.

- Relatedly, with regard to ETFs, BlackRock recommends that the Agencies amend the proposal to permit a banking organization to apply a collateral haircut based on the characteristics of the underlying assets of the ETF when it has knowledge of the composition of all of the underlying exposures (referred to as a look-through approach).
- SFTs serve an important role in the efficient functioning of the securities trading market in the U.S and BlackRock therefore urges the Agencies to consider the aforementioned recommendations to ensure the continued efficiency of U.S. markets.

3 The Agencies should modify to the risk-weight treatment of closed-end preferred stock to align its risk weighting with similarly situated securities.

- The Basel Proposal would substantially increase the risk-weighting of preferred shares issued by closed-end funds by classifying such securities as "subordinated debt instruments" despite the fact that such shares are (i) considered senior securities under the Investment Company Act of 1940 ("40 Act"); (ii) structured to serve as the most senior form of leverage in a closed-end fund's capital structure; and (iii) the funds themselves are subject to regulatory oversight and stringent limitations on leverage.[2]
- Furthermore, this proposed amendment would further heighten the incongruous risk-weighting treatment these securities currently receive relative to other types of similarly situated senior securities and could inadvertently eliminate an efficient and prudent form of leverage to certain registered closed-end funds (particularly municipal securities closed-end funds).
- BlackRock recommends excluding preferred stock in 40 Act closed-end funds from the definition of "subordinated debt." This would ensure that preferred shares receive a risk weighting of at least 100% but also remain eligible for a 65% risk weighting if the issuing entity qualifies.
- We believe our recommended approach would avert the potential reduction in demand for closed-end fund preferred shares and/or the sharp rise in their issuance cost that could result from proceeding with the proposed amendments.

4 The GSIB Surcharge Proposal is an opportunity to holistically improve the current treatment of ETFs to more accurately reflect the credit quality of their underlying assets.

- Under the current GSIB Surcharge rules, ETFs are scored more punitively than (i) the constituent securities that compose the funds' holdings and (ii) other securities that provide comparable economic exposures (e.g., index futures), resulting in higher capital costs for U.S. GSIBs using ETFs.
- In some cases, this punitive treatment has impacted the trading behavior of U.S. GSIBs over scoring periods, including how they manage capital to meet quarter-end targets, their appetite to provide liquidity to ETFs, and ability to recognize the benefits of using ETFs as hedging vehicles to reduce risk (e.g., liquidity at a generally low cost).
- By expanding the definition of "financial institution" to include ETFs, the GSIB Surcharge Proposal would further increase the GSIB score for ETFs (and, therefore, the capital surcharge for U.S. GSIBs using ETFs).
- Increased capital surcharges for ETFs could diminish liquidity in these products, ultimately increasing the cost of using ETFs for investors.
- BlackRock recommends amending the GSIB Surcharge Proposal to exclude ETFs from the definition of "financial institutions."
- We believe that the unique structure of ETFs—including the presence of "primary" and "secondary" market trading—along with existing regulatory obligations on the funds, adequately addresses the interconnectedness concerns in the proposal, thus justifying an exclusion from the "financial institution" definition.[3]
- In addition to excluding ETFs from the definition of "financial institution" under the GSIB Surcharge proposal, we encourage the Board to reconsider

[2] The proposed definition of a "subordinated debt" instrument would capture exposures that are financial instruments and, in the view of the Agencies, present heightened credit risk but are not equity exposures and would include "preferred stock that is not an equity exposure."

[3] Unlike other investment funds included in the definition of "financial institution," ETF investors do not interact directly with the fund provider when buying or selling shares. Instead, ETF investors generally trade existing ETF shares with each other during market hours, on an exchange, just like trading stocks (the "secondary" market). When demand cannot be met in the secondary market, a separate, "primary" market exists where large institutions (authorized participants, "APs") can transact with ETF issuers to create or redeem ETF shares based on market demand. The combination of robust primary and secondary markets and the availability of in-kind redemptions for ETF shares mitigates the risk that ETFs will become pro-cyclical contributors of systemic risk during times of market stress.

the treatment of ETFs under the current GSIB Surcharge rule and reduce the scoring weight of ETFs to align more closely with the credit risk of the fund's underlying securities.

- Absent these recommended changes, we believe that many banking organizations will have a diminished ability and risk appetite to serve as liquidity providers in the ETF market, which could lead to greater volatility and decreased liquidity (higher transaction costs) in those markets.

5 We believe the GSIB Surcharge should not include agency model cleared OTC derivatives in the systemic indicators of the calculation.

- In the GSIB Surcharge Proposal, the Board has proposed amending the complexity and interconnected indicators (components used to calculate GSIB surcharges) to include cleared over-the-counter ("OTC") derivatives provided to clients under the agency model with the goal of promoting consistent treatment between principal and agency clearing models.[4]

- We believe enactment of the proposed amendments would negatively impact the availability and affordability of cleared derivatives for end-users, particularly those clearing through U.S. GSIBs.
- We believe including these transactions in additional indicators of the GSIB calculation would unnecessarily overweight the risk these exposures pose to banks and disadvantage U.S. GSIBs relative to non-U.S. GSIBs.
- We urge the Board to fully analyze the microeconomic impact that the GSIB Surcharge Proposal could have on the provision and use of derivatives clearing services that could in turn increase systemic risk.

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[4] Under the principal model, a banking organization enters into equal and offsetting trades as principal directly with the client and the Central Counterparty Clearing House (CCP). Under the agency model, a banking organization acts as agent for its client, which enters into the derivative directly with a CCP. The banking organization typically guarantees the client's performance to the CCP.

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