

The use and valuation of funds as eligible collateral to mitigate credit risk



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The Basel Framework is a set of global banking regulations by the Basel Committee on Banking Supervision (BCBS)¹. Aimed at strengthening bank supervision and financial stability the framework sets minimum capital requirements for credit institutions. The implementation of the final version of Basel accords introduces tighter risk weighting of counterparty exposures and an increase in minimum capital requirements for credit institutions. This article argues that financial institutions should widen their acceptable collateral to include fund units and explains how they can overcome the associated data challenges.

Institutions can strengthen their credit risk mitigation strategy by effectively leveraging non-cash collateral to reduce credit exposures and free up capital for business growth. This requires the ability to accurately identify eligible collateral and assess its quality and value.

Why is credit risk mitigation important for financial institutions?

Under Basel rules financial institutions can reduce their credit risk by accepting eligible collateral in the form of financial instruments for secured lending. By utilising collateral pledged as security to perform credit risk mitigation, banks can effectively offset the value against corresponding counterparty credit exposures.

Impact of Basel final implementation

The final version of Basel III, or Basel III Final, (informally known as Basel IV in the EU) in January 2025 introduces an output floor intended to promote the harmonisation of capital requirements calculations across banks. This has been designed to ensure that capital requirements calculated using

a bank's internal models cannot be less than 72.5% of the capital requirements calculated using standardised approach.

Whilst the output floor is introduced on a transitional basis to reach 72.5% in 2030, European banks will see a sharp 5% increase from the initial 50% base in January 2026, resulting in institutions seeking opportunities to optimise capital.

In short, the more eligible assets that can be identified and valued, the greater the opportunity to reduce individual credit risk exposures and, in turn, the lower the overall requirements for the regulatory capital that a financial institution must hold.

Which financial instruments can be considered as eligible collateral for bank lending?

The pool of eligible collateral typically includes high-quality bonds and listed equities as they are liquid and easy to mark to market.

However, holdings in funds, such as mutual funds and **exchange-traded funds**, are also permitted as eligible collateral subject to meeting specific criteria. Funds being used as collateral in lending transactions have so far led a niche existence but could prove to be an attractive alternative in the wake of the rollout of the final transposition of the Basel accords.

Funds as collateral: what are the opportunities?

It is clear that **Basel III/IV** forms the basis for a stricter view of the risks to which financial institutions are exposed. The

1. Basel Committee on Banking Supervision (BCBS): https://www.bis.org/basel_framework/

introduction of additional risk sensitivities will result in higher risk weights for some exposures. The pricing of collateral in securities financing will need to be adjusted to mitigate the increase in minimum capital requirements.

Conversely, the regulations make clear how individual credit risk exposures can be mitigated to optimise an institution's overall capital position. As noted above, liquid assets such as high-quality shares and bonds constitute the bulk of non-cash collateral. However, investment funds may also qualify as high-quality collateral if they meet the conditions set out in the Basel framework. A key prerequisite is the institution's ability to determine the appropriate haircut for each fund.

What is a haircut?

The haircut, in the context of eligible collateral,² describes the deduction to the market value of an asset when it is used as eligible collateral. It is based on asset type and currency volatility. The amount of the deduction depends on the risk of the underlying asset.

To determine the haircut, i.e. to value the fund positions that financial institutions have received as collateral from borrowers, they can use the mandate-based approach. However, this approach is only a conservative estimation based on the stated investment profile of the fund. As such, it does not allow for the most efficient use of capital. Financial institutions are giving away potential that they could use elsewhere.

The most capital-efficient method for assessing funds under the standardised approach, suggested in the Basel framework, is by implementing the **Look-Through Approach (LTA)**. By adopting the LTA, financial institutions that accept funds as collateral can improve the risk weighting of the banking book and thus have a positive influence on capital requirements.

As a result, more capital is freed up to carry out yield transactions. The more often and systematically a financial institution uses the LTA in connection with funds, the more capital is available for further loans or investments.

However, the LTA entails identifying each component of a fund as a direct investment i.e., as if each underlying component were held as an individual position by the financial institution.

Funds as collateral: what are the challenges?

The haircut for the fund as a whole can only be determined by the average haircut of all the assets underlying the fund. Not an easy task, considering that a fund naturally consists of many different components, each of which needs to be accurately identified and assessed.

Therefore, when using the LTA, the financial institution needs to identify the underlying assets and their corresponding weights and assess the eligibility of each position before being able to apply the corresponding volatility adjustments – or haircuts. The more precisely this can be done, the lower the overall haircut will be for the fund.

While the LTA is recognised as the most capital-efficient approach, it is also a data- and resource-intensive process. It requires granular data collection and normalisation from multiple asset managers, which impacts IT resources and costs.

As a result, some financial institutions often resort to manually collecting the data required for the LTA through so-called scraping, i.e., retrieving data from asset management websites. This method is not only inefficient, but also prone to producing inaccurate and outdated data.

With the right data, funds become an alternative asset class to collateralise loans

If financial institutions want to use fund-based collateral in the most capital-efficient way, this is only possible via adoption of the LTA. Applying the LTA to funds, however, demands granular look-through data and robust automation. This, in turn, requires aggregating and standardising data in multiple formats directly from asset managers.

This is where data providers become essential. By leveraging their industry connections and data-management expertise, they can continuously aggregate, standardise, and update information on the relevant assets through automated processes.

By combining this core competence with the necessary Basel data enrichment, they can provide a financial institution with all the granular information needed to value the funds comprehensively and in a timely fashion, in accordance with the regulatory requirements.

Thus, accepting funds as collateral is no longer a challenge for financial institutions, but rather an opportunity.

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2. BCBS CRE22 Standardised approach credit risk mitigation. This is not the same definition or determination of haircuts applied in securities financing transactions.