ACLI
Financial Security. For Life.

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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SUBMITTED via E-MAIL: baselcommittee@bis.org

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Re: BCBS Revised Basel III Leverage Ratio Framework

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. In addition to providing life insurance, annuity and employee benefit programs on a global basis, many of our members are large participants in the fixed income markets, including U.S. Treasury securities, as well as repurchase and reverse repurchase agreements. Our members manage asset and liability risks by hedging with derivatives instruments.

We respectfully submit our comments on the Consultative Document issued by the Basel Committee on Banking Supervision outlining the Revised Basel III Leverage Ratio Framework[1] (the "Revised Leverage Ratio Framework"), an important component of the overall regulatory framework for the Banking sector. Life insurers are among the financial end users affected by the leverage ratios under consideration in the Consultative Document. Life insurers have actively participated in the global dialogue concerning the regulation of derivatives. We greatly appreciate your attention to our views

I. Summary of Position

ACLI recognizes the substantial effort and consideration that the Basel Committee on Banking Supervision has dedicated to introducing a transparent, supplementary measure to the Risk Based Capital ("RBC") requirements for Banks. Further, the ACLI fully recognizes the important implications for ensuring a global regulatory framework for more resilient banks and banking systems. However, the Revised Leverage Ratio Framework, as written, has the potential of creating several negative market consequences in its attempt to mitigate broader systemic risks.

In particular, we are concerned about the potential impact to the fixed income and derivative markets. Specifically, we believe that large portions of the fixed income and derivatives markets will be impacted from proposed changes to the netting of Securities Financing Transactions (SFTs). Additionally, the Derivatives markets will also suffer a negative impact from the inclusion of cash collateral in the Exposure Measure. Finally, we believe that the Credit Derivatives markets are likely to be adversely affected from more restrictive off-sets for purchased credit derivatives.

[1] http://www.bis.org/publ/bcbs251.pdf

II. Discussion

The table below summarizes what we believe are the market impacts from the proposed changes:

Market Sector	Exposure Measure Driver	Expected Market Impact
SFTs	No recognition of netting	▪ Reduced depth and liquidity ▪ Wider bid-ask spreads ▪ Spill over impact to all fixed income markets where market liquidity depends on an efficient and liquid financing market (e.g. Government security and derivatives markets)
Derivatives	Inclusion of cash collateral	▪ Reduced depth and liquidity ▪ Wider bid-ask spreads ▪ At odds with global derivatives reform requirements
Credit Derivatives	Limited netting of written credit derivatives	▪ Reduced depth and liquidity ▪ Wider bid-ask spreads

(A) Securities Financing Transactions (SFTs)

The Revised Leverage Ratio Framework proposes the inclusion of STFs on a gross basis, with the removal of accounting netting. We strongly believe that dis-allowing exposure netting for SFTs will have a profound negative impact on the financial markets that depend on these types of transactions, including Repurchase and Reverse Repurchase Transactions, for short and intermediate term financing. Specifically, we believe that this proposed change to the Revised Leverage Ratio will drastically reduce the depth and liquidity of these markets, increase the costs of short and intermediate term financing by increasing the bid-ask spreads for these transactions and ultimately reduce the liquidity in the fixed income markets for the securities underlying these financing transactions, specifically the market for U.S. Government Securities.

SFT's strengthen the Government Securities markets by significantly deepening the liquidity of those securities and allowing brokers to efficiently fulfill their role as primary dealers while cost effectively maintaining a lower level of inventory in these securities. The proposed removal of exposure netting would discourage dealers from engaging in these SFTs of Government Securities with each other, thereby disrupting the efficient allocation of these resources to the best uses. The result of this proposed modification would be a dramatically reduced dealer willingness to facilitate SFT transactions, causing a drop in liquidity and a widening of bid/ask spreads on highly liquid assets (such as U.S. Treasuries). Moreover, reducing the liquidity for these securities will ultimately increase the volatility in bond yields across the broader fixed income markets.

It is worth noting that the U.S. Treasury has $11Tn of debt outstanding. The daily trading volume of U.S. Treasuries is over $500Bn, making it one of the deepest and most liquid sectors in the marketplace. Further, U.S. Treasuries have proven to be the safest and soundest asset class during a crisis period. The proposed treatment of SFTs and the resulting penalization for holding high quality liquid assets (HQLA) is at odds with Basel III liquidity framework's Liquidity Coverage Ratio (LCR), which is designed to ensure that banks maintain a resilient liquidity risk profile and hold an adequate stock of unencumbered HQLA

The liquidity impact on the broader fixed income markets would be negative to the core investment holdings of ACLI members. U.S. Treasury securities are used by insurers for a myriad of reasons including core investments, the management of liquidity and duration in their portfolio, asset liability management and fulfillment of collateral requirements for borrowing and hedging activities. The proposed treatment of SFTs discourages financial intermediaries from holding HQLA such as Treasuries, and potentially dissuades Primary Dealers from participating in Treasury market auctions. This could result in a shift in the depth and breadth of the U.S. Treasury market resulting in wider bid/ask spreads, a reduction in liquidity and potentially broader consequences for the global financial markets.

(B) Derivatives

The Revised Leverage Ratio includes cash collateral obtained in respect of derivatives transactions in the Exposure Measure. The ACLI believes that the exchange of high quality collateral (particularly cash) in connection with derivatives transactions is systemically risk reductive and should be encouraged rather than discouraged. Including cash collateral in the Exposure Measure creates a strong disincentive for derivatives market making activities because the associated capital charges will become prohibitive, thereby impacting the liquidity in these markets. This condition will likely increase the costs of hedging by end-users, or potentially force them to abandon the appropriate use of derivatives to prudently hedge market risks. Further, including cash collateral in the Exposure Measure may lead to a reduction of the use of cash collateral to satisfy margin requirements for non-centrally cleared derivatives. Reduced liquidity in the Treasury markets combined with the inclusion of cash collateral in the Exposure Measure will lead to increased costs for market participants.

ACLI members regularly use derivative instruments (including Credit Derivatives) to responsibly and effectively hedge the risks associated with their investment portfolios and insurance and annuity product liabilities. The insurance industry's continued ability to manage and hedge financial risk through the use of derivatives is an essential component of its risk management program.

(C) Credit Derivatives

The Revised Leverage Ratio stipulates a number of requirements that need to be met in order for a Financial Institution to be able to offset credit derivative positions referencing the same entity. Among these, the requirement that the purchased credit default swap must be longer in maturity than the remaining maturity of the written credit default swap appears to be particularly onerous. A purchased credit default swap that is shorter in maturity than a sold credit default swap referencing the same entity provides significant risk reduction, though not 100%, especially in the event of a default of the reference entity. The additional requirements of the proposal targeting credit derivatives would likely have the effect of widening bid-ask spreads and reducing liquidity in that market for buy-side participants.

ACLI members use credit derivatives to manage the credit risk of their investment portfolios. Having the ability to use credit derivatives to manage credit risk is a central component of their overall investment portfolio strategies. The inability to proportionally net written and purchase credit derivatives exposure by derivatives market makers will ultimately decrease liquidity in this market and increase costs which will impair ACLI members' ability to execute their portfolio strategies.

III. Proposed Modifications

The ACLI understands that the Basel III reform introducing a simple, transparent, non-risk based leverage ratio is intended as a credible supplementary measure to RBC requirements. We also understand that the leverage ratio is intended to restrict the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. However, as described above, we believe that certain aspects of the proposal will significantly impair market functionality, liquidity and transaction costs in markets that the insurance industry relies upon. Accordingly, we respectfully suggest that the Committee consider the following modifications:

- Continued allowance of netting for Securities Financing Transactions when the underlying securities consist of Government Securities;
- Exclusion of cash collateral posted or received in connection with derivatives transactions; and
- Recognition of maturity mismatches on a proportional basis in respect of credit derivatives.

IV. Conclusion

The ACLI would like to reiterate our appreciation for the thoughtful approach that the Basel Committee on Banking Supervision has taken regarding the Leverage Ratio calculation We are pleased to be able to continue to participate through the comment process and respectfully submit that certain aspects discussed above have the potential to unintentionally reduce market liquidity and increase costs in the fixed income and derivative markets. We believe that failure to modify the items listed above will unnecessarily increase costs to ACLI members and their customers.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

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