

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
e: baselcommittee@bis.org

20 September 2013

Re: BCBS 251 – Revised Basel III leverage ratio framework and disclosure requirements

Dear Secretariat,

This paper provides the response of the LCH.Clearnet Group ("LCH.Clearnet") to the BCBS Consultative Document 251.

LCH.Clearnet is the world's leading clearing house group, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including: equity securities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, FX derivatives, bonds and repos. The Firm works closely with market participants and exchanges to identify and develop clearing services for new asset classes.

LCH.Clearnet welcomes the opportunity to respond to this consultation. Our response focuses on the impact of the proposal on transactions that are cleared by a CCP.

Our key concern with regards to the implementation of a capital requirement based on a Leverage Ratio (LR) exposure measure is the impact on client clearing resulting in client clearing transactions being costlier than bilateral (non-cleared) transactions from a capital perspective.⁴ Additionally, we would like to highlight an apparent discrepancy between the treatment of "agency" and "principal" models.

The FCM model in operation in the US for cleared swaps customers can be characterised as an agency model, whereas that generally operating in Europe and elsewhere involves the clearing broker (CB) acting as a principal intermediary between customer and CCP. CBs clearing for their customers under a principal model will be required to include both the CCP facing trade and the client facing trade when calculating the LR exposure, thereby doubling the reported Notional value relative to the treatment under the agency model. In practice, the agency and principal models are economically equivalent, both being hybrids in which (1) the FCM or CB guarantees performance of the client to the CCP; but (2) the FCM or CB does not guarantee the performance of the CCP to the client. The characterisation in the context of the LR exposure as "agency" or "principal" is therefore ultimately misleading. On this basis, we recommend equivalent treatment of the two clearing models for the purposes of calculating LR exposures.

Where the CB is also acting as the Executing Broker (EB), in both models the member will be required to include an additional leg of the cleared transaction in the calculation of the LR exposure. A \$100million swap executed and documented bilaterally with a client and currently reported as \$100million exposure for LR purposes would, when cleared for the client by the same firm under a principal model, result in a reported \$300 million exposure. As intermediaries of the cleared transaction, the CBs and/or FCMs are not in a position to leverage the collateral they receive from

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clients as this collateral is posted to the CCP. Hence, the CBs and/or FCMs are not increasing the leveraging of their balance sheets. However, implementation of this proposal would require the CBs and/or FCMs to hold significantly more regulatory capital in order to comply with the proposed requirement of a minimum 3% capitalisation of the Leverage Ratio Exposure. This could result in client clearing becoming significantly more costly than it is currently. This proposal may also disincentivise clients from clearing their OTC transactions which may be considered to be at odds with the G20 commitments of encouraging the use of Central Clearing.

We would recommend that since collateral being posted by clients is passed on to the CCP, and therefore cannot be used by the CB/FCM to leverage their balance sheet, that client cleared transactions, including both the client facing and CCP facing legs, not be included in the calculation of the LR exposure. However, in the case that a client posts a greater amount of collateral than that being posted to the clearing house, inclusion within the LR exposure may apply. As a minimum, we would recommend a consistent treatment between the agency and principal models in order to avoid regulatory arbitrage.

One of the drawbacks of the Leverage Ratio proposal is that the LR exposure measures leverage as represented by the Notional value of the trade as opposed to a more risk-sensitive measure accounting for the nature of the financial instrument in a portfolio context. We understand that one of the aims of the LR is to act as a backstop capital requirement which is not risk-sensitive. However, this can result in low risk products being measured on par with high risk products. A consequence of such an approach is that low risk investments will appear to be more costly from a capital perspective relative to a high risk investment when considering the potential profit opportunity of the high risk trade. This can lead to the unexpected consequence of investment being driven to higher risk instruments due to their capital treatment.

Finally, the add-on factors applied to FX Forwards (see Appendix 1), for the purpose of calculating potential future exposure, create a significant cliff effect between the 1Y tenor and beyond (1% under 1Y and 5% from 1Y to 5Y). This could result in low risk (volatility) instruments being measured as being much riskier than a relatively high risk (volatility) instrument. For example, Historically, USD/Russian Ruble annualized volatilities have been above 20% whereas, USD/Sterling volatilities have generally been around 10%. However, they would be treated as per the example shown below (see Table 1) in the context of the LR exposure calculation.

Table 1 - Example of the calculation of Potential Future Exposure for FX Forwards

Instrument	Currency Pair	Residual Maturity	Notional Value (USD)	add-on factor	Potential Future Exposure (USD)
FX Forward	USD/GBP	13 months	\$100,000,000	5%	\$5,000,000
FX Forward	USD/RUB	11 months	\$100,000,000	1%	\$1,000,000

We would suggest that the add-on factors be applied with a greater level of granularity than by asset class and maturity buckets alone. By grouping currency pairs according to their historical volatilities, it may be possible to apply add-on factors which are more reflective of the magnitude of the potential future exposure according to their respective levels of risk as represented by volatility.

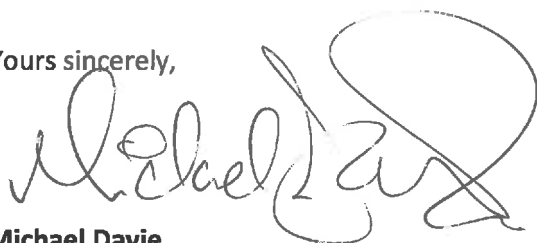
In conclusion, we would welcome the implementation of the LR framework in order to limit excessive leverage of bank balance sheets, however, the approach should:

- a) avoid making the cost of clearing disproportionately high for clients by excluding client cleared transactions from the LR exposure when client margins are posted to the CCP in full,

- b) avoid regulatory arbitrage by aligning treatments of client cleared transactions across the agency and principal clearing models,
- c) avoid driving business away from low risk (lower yielding) to high risk products by introducing some level of risk-sensitivity via the calibration of PFE add-on factors, and
- d) ensure that cliff effects in the LR exposure calculation are avoided and that add-on factors be reduced for products which can be justified as being less risky (by introducing currency pair (volatility-based) grouping with respect to the treatment of FX Forwards in particular).

We trust that our comments will assist the BCBS in calibrating the Leverage Ratio framework. Should you have any questions or issues arising from this response please contact Bipin Patel at LCH.Clearnet on bipin.patel@lchclearnet.com.

Yours sincerely,



Michael Davie
Managing Director, LCH.Clearnet

Appendix 1

Figure 1 - Add-on factors for calculating Potential Future Exposure (extracted from BCBS 251)

Derivative exposures

Add-on factors for determining potential future exposure

1. The following add-on factors apply to financial derivatives, based on residual maturity:

	Interest rates	FX and gold	Equities	Precious metals except gold	Other commodities
One year or less	0.0%	1.0%	6.0%	7.0%	10.0%
Over one year to five years	0.5%	5.0%	8.0%	7.0%	12.0%
Over five years	1.5%	7.5%	10.0%	8.0%	15.0%