AFR Americans for Financial Reform

Education Fund

January 16, 2019
Basel Committee on Banking Supervision

RE: Leverage ratio treatment of client cleared derivatives

On behalf of Americans for Financial Reform Education Fund (AFR Education Fund), thank you for the opportunity to provide comment on this consultative document. Americans for Financial Reform is an unprecedented coalition of more than 200 American civil society groups who have come together to advocate for stronger and more effective financial regulation in the public interest. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups.[1]

This consultative document solicits views on whether capital requirements for banks providing clearing services should be reduced by permitting such banks to offset client margin against their leverage ratio derivatives exposure. This change would manifestly permit clearing banks to be more leveraged and thus increase the possibility that a clearing member of a major derivatives central counterparty (CCP) would become insolvent. It would also reduce the total resources available at solvent clearing members in responding to a possible CCP default. The consultative document makes no claim that the analytic case for such a change has been fully made but instead invites stakeholders to provide "concrete and robust evidence" that the change is needed.

The majority of stakeholders in this case will be clearing banks. These banks can directly increase the returns on equity in their clearing business by being permitted to reduce their required capital. Certainly such banks will have the best access to data that can be selected to make a case. However, these banks are also interested parties that will be highly motivated to make any argument that will result in lower capital charges. Other industry stakeholders may also have indirect interests in lowering the resources necessary for providing clearing services.

In such a situation the regulatory community, especially bank regulators who are the leading experts on bank solvency, has the responsibility to provide unbiased data and thorough analysis that explore whether or not the benefits of a reduction in the leverage ratio will truly exceed the costs. Neither this consultative document nor other BIS publications on this issue have done so.

This consultative document cites to the policy objectives in the 2009 G-20 Leader's Summit in stating that promoting central clearing is a key policy goal. Yet as the document also notes, the 2009 summit statement also includes an even clearer commitment to reduce leverage and increase the quantity of capital in the banking system. (Furthermore, the G-20 summit only commits to promoting the clearing of "standardized" derivatives contracts "where appropriate"). In light of the commitment to increase capital and reduce leverage, it seems incumbent on the regulatory community to seek means of promoting central clearing that do not rely on increasing leverage and slashing capital requirements. Mandating clearing of standardized derivatives is a clear path to do this which has already been adopted and implemented in most G-20 countries and could be strengthened further.

[1] Further information is available at the AFR Education Fund web site, http://www.realbankreform.org

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The consultative document also cites to the recent joint regulatory study on "Incentives to Centrally Clear Over-the-Counter Derivatives".[2] This study includes the results of a survey of dealers in which bank providers of clearing services claim that the leverage ratio acts as a constraint. It also references a Bank of England study which finds evidence of a small (five percent) reduction in client cleared transactions at affected banks due to the implementation of the U.K. leverage ratio.[3] However, neither the survey nor the academic papers make any effort to comprehensively weigh the benefits of the leverage ratio in improving bank solvency against its potential negative effects on clearing services. Nor does the joint study contain an exploration of regulatory options other than reducing leverage capital in improving incentives to provide clearing services.

Rather than proceed on the basis of data provided by interested parties in industry, we urge global banking regulators to undertake a truly comprehensive examination of the potential costs and benefits of reducing leverage ratio requirements for clearing banks. Such an examination should project the actual increase in clearing services that could be expected from such a reduction, and estimate the actual declines in capital at clearing banks that would result. These two elements of the analysis must be conducted jointly, since if the change in the leverage ratio actually increases clearing volumes it will also have a more significant impact on capital than can be assessed solely from current clearing volumes.

In assessing the potential social costs of reductions in capital at clearing banks, regulators should be analyze the total capital available to support the cleared derivatives ecosystem and whether this capital will truly be adequate in a stressed situation. Under current rules, clearing members must hold risk-based capital against individual positions and also some capital against their share of the default fund. But all other mutualized risks or exposures beyond the default fund are not capitalized. These include upward adjustments of the default fund in stressed markets, capital assessments beyond the default fund, and the potential need to assume positions from a defaulted member in an auction. Managing these potential events requires solvent clearing members.

In addition, regulators should also assess the operational risks of client clearing, including the margin guarantees involved, and whether minimum levels of capital are required to support cleared derivatives even when they are margined. Cases such as the collapse of the U.S. bank MF Global, in which customer funds were lost, should be part of this assessment. Regulators should also be cognizant of the conceptual issues with incorporating risk mitigants such as margin into leverage ratio calculations, and the precedent this may set in blurring the distinction between leverage and risk-based capital.

Thank you for your attention to this letter. If you have questions, contact the AFR Education Fund's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or at 202-466-3672.

Sincerely,
Americans for Financial Reform Education Fund

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[2] BCBS, CPMI, "Incentives to Centrally Clear Over the Counter Derivatives", November, 2018. https://www.bis.org/publ/othp29.htm

[3] Acosta-Smith, Gerardo Ferrara, and Francesc Rodriguez, "The Impact of the Leverage Ratio on Client Clearing", Bank of England Working Paper No. 735, June 2018. https://www.bankofengland.co.uk/working-paper/2018/the-impact-of-the-leverage-ratio-on-client-clearing