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5 July, 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Mr. Coen:

Re: Consultative Document on Revisions to the Basel III leverage ratio framework

Brevan Howard Investment Products Ltd (“**Brevan Howard**”)¹ welcomes the opportunity to comment on the Consultative Document on Revisions to the Basel III leverage ratio framework published in April 2016 (“**d365**”)², a follow-up to the Basel III leverage ratio framework and disclosure requirements document published in January 2014 (“**bcbs270**”)³.

We note that bcbs270 proposes the adoption, for the purposes of the Basel III leverage ratio framework, of a modified version of the standardised approach for measuring counterparty credit risk exposures (“**SA-CCR**”). We strongly support the use of SA-CCR because while it is more complex than the models it replaces, it vastly improves risk sensitivity, corrects other known deficiencies of previous models, addresses the impact of recent moves towards central clearing of OTC derivatives,

¹ Brevan Howard is a global alternative asset manager that manages institutional assets across a number of diversified strategies.

² Revisions to the Basel III leverage ratio framework - consultative document, <http://www.bis.org/bcbs/publ/d365.htm>

³ Basel III leverage ratio framework and disclosure requirements, <http://www.bis.org/publ/bcbs270.pdf>

retains a conservative approach in its methodology and is a deterministic framework which minimises discretion.

We do however think that the proposal to ignore the impact of initial margin in the calculation of potential future exposure (“**PFE**”) is inconsistent and contradictory when considered against other aspects of the proposals.

As noted in the consultative document, the Basel III leverage ratio framework states that “banks must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the [leverage ratio] exposure measure” (bcbs270, paragraph 13). However bcbs270 goes on to state that “the cash portion of variation margin exchanged between counterparties may be viewed as a form of pre-settlement payment” (paragraph 25), in other words variation margin is an advance settlement payment in respect of the potential expiry of the derivative portfolio at prevailing market prices.

In our view, initial margin should also be regarded as a pre-settlement payment, not in respect of the current value of the derivative portfolio, but in respect of losses incurred in the event of default by the client. Just like variation margin, the amounts paid by way of initial margin “pre-settlement” may eventually be paid back to the client; in the case of variation margin, repayment may occur if market prices change, and in the case of initial margin, repayment will occur if the client does not default. It is therefore inconsistent to propose that initial margin in the form of cash must be treated in a different way to variation margin in the form of cash.

Further, cash is a unique form of pre-settlement “collateral” because in the hands of the recipient it carries no market or credit risk. It is therefore not a form of “physical or financial collateral” or a “credit risk mitigation technique”, but an advance payment in respect of a potential liability.

We therefore propose that in order to avoid inconsistency and contradictions, initial margin paid by a client to a bank (even if held in a segregated client account, provided the bank has a fully effective legal charge over the account) should be treated as an offset to PFE.

The above analysis applies to non-cleared OTC derivative relationships between banks and clients and also to cases where a bank, as a clearing member (“**CM**”) of a central counterparty (“**CCP**”) stands between the client and the CCP. The case addressed in paragraph 28 of bcbs270 – where a client enters directly into a derivatives transaction with the CCP and the CM guarantees the performance of its clients’ derivative trade exposures to the CCP – necessitates a different analysis. In this case the approach applied by bcbs270 should be consistent with the general approach taken in respect of guarantees, namely that the exposure calculation should reflect the anticipated potential liability under the guarantee. For example, paragraph 36 of bcbs270 makes this specific point in the case where a bank acting as agent in a securities financing transaction provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided.

Where a client enters directly into a derivatives transaction with the CCP and the client makes initial and variation margin payments direct to the CCP, the CCP will

only claim on the CM's guarantee if the client defaults and the CCP suffers a loss after exhausting all of the client's initial and variation margin. Therefore the potential liability under the guarantee is the excess risk once all of the margin payments have been taken into consideration.

We therefore propose that where a client enters directly into a derivatives transaction with the CCP, with a CM guaranteeing the performance of the client's derivative trade exposures to the CCP, the CM's exposure calculation must take initial margin into consideration as an offset to PFE, otherwise the treatment of this guarantee will be inconsistent with the treatment of other types of guarantee.

Brevan Howard appreciates the Committee's consideration of its views. Please do not hesitate to contact me with any questions at aron.landy@brevanhoward.com.

Sincerely yours,

A handwritten signature in black ink, appearing to be 'Aron Landy', with a long horizontal flourish extending to the right.

Dr. Aron Landy
Partner and Chief Risk Officer
Brevan Howard Investment Products Limited St
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