ASSOCIATION DES BANQUIERS CANADIENS | CANADIAN BANKERS ASSOCIATION

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Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

January 16, 2019

Dear Basel Committee members:

Re: CBA[1] Comments on BCBS Consultative Document *Leverage ratio treatment of client cleared derivatives*

Thank you for the opportunity to provide comments on the BCBS's consultative document *Leverage ratio treatment of client cleared derivatives* ("the consultative document"). We note the Committee's stated request for concrete and robust empirical evidence for revising the current leverage ratio treatment of client cleared derivatives. We believe that the data provided to the BCBS through the Basel III monitoring exercise and by various industry associations should be enough to confirm that revisions are required. For example, in response to an earlier BCBS consultation on the leverage ratio, the Futures Industry Association (FIA) collected data which revealed that the aggregate leverage exposure of 14 participating firms would be 80 percent higher under SA-CCR without Initial Margin (IM) offset compared to SA-CCR with IM offset[2]. In addition, we provide below a more recent example of the impact of the leverage ratio on the client clearing industry.

We have considered the three options presented in the consultative document and we support Option 3. However, we would also like to suggest a fourth option, the alignment of capital and leverage derivative rules, which we respectfully submit to the Committee for consideration as the international standard. This fourth option as outlined below is currently accepted in Canada. We are in favour of this fourth option which reduces the operational burden of having different approaches for capital and leverage by recognizing both cash and non-cash forms of IM and Variation Margin (VM) received to offset Replacement Cost (RC) and Potential Future Exposure (PFE) for all derivative trades for leverage purposes similar to that allowed for capital purposes under SA-CCR. Finally, we also provide our views on the Committee's question related to the segregation of IM.

Impact of leverage ratio on client clearing

We believe there is more than sufficient industry data supporting the fact that the BCBS leverage ratio rules have impacted client clearing activities. In their final report *Incentives to centrally clear over-the-counter (OTC) derivatives*, a group of regulators including the BCBS note that the majority of respondents to a client clearing service provider survey stated that the leverage ratio was the only capital standard that acted as a disincentive to the provision of client clearing services[3]. As a specific example, Geneva Energy Markets LLC, one of the largest market-makers in crude oil and refined products, recently shut down its operations due to regulatory constraints. The former Managing Partner highlighted the impact of the leverage ratio, noting that "The change to gross

[1] The Canadian Bankers Association is the voice of more than 60 domestic and foreign banks that help drive Canada's economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca.
[2] See p. 5 of FIA submission to the BCBS (July 6, 2016): https://fia.org/sites/default/files/2016-07-06_FIA_Comment_Letter_Basel_Committee_Leverage_Ratio.pdf
[3] See p. 64 of FSB/BCBS/CPMI/IOSCO final report *Incentives to centrally clear over-the-counter OTC derivatives* (November 19, 2018): https://www.bis.org/publ/othp29.pdf

exposure meant a significant increase in capital requirement for our clearing bank, and we were asked to reduce our positions massively".[4]

We also believe that the BCBS has not considered the impact of the leverage ratio on client cleared derivatives at a regional level and, specifically, from the legal entity point of view. It is at the regional/subsidiary level that firms are more severely impacted by the leverage ratio rules and where capital must be managed more efficiently. The capital structure at the regional/legal entity level is different from the capital structure at the group level for most firms. This puts pressure on firms' client clearing activities. For example, futures clearing businesses are low users of capital but are being heavily penalized by leverage constraints under current BCBS requirements. Should the existing Basel QIS data not be sufficient, we recommend that the Committee undertake a review of the leverage ratio framework at the legal entity level as this will provide greater insight into how the rules are impacting many subsidiaries of international banks and why changes are needed.

<u>Options presented in the consultative document</u>

With the above in mind, we do not support Option 1 in the consultative document to retain the existing leverage ratio treatment for client cleared derivatives.

We also have concerns with Option 2. We note that this option provides limited benefit for client clearing of derivatives as only Cash Variation Margin (CVM) is allowed to be used as an offset in the RC formula. This option does not provide full relief as it does not allow for the inclusion of IM as an offset. Option 2 also does not allow the Net Independent Collateral Amount (NICA) prescribed under paragraph 143 of the SA-CCR rules to be appropriately included in the determination of RC. Option 2 also does not permit the recognition of cash and non-cash IM <u>provided</u> in determining the PFE. Refining the PFE multiplier by excluding only VM (compared to the SA-CCR methodology) is also conservative. Overall, we do not support Option 2 as we find that it provides only limited benefits.

Given the options presented, we support Option 3 as it permits both cash and non-cash forms of IM and VM received from the client to offset RC and PFE for client cleared derivatives. We believe that Option 3 provides greater incentives to offer clearing services since it would lead to lower costs and prices, thereby making clearing services more accessible. This option could also potentially increase the number of market participants offering clearing services. Option 3 is thus better aligned with the G7 mandate to encourage clearing of derivatives. We believe the adoption of Option 3 would lead to a more favorable dynamic in the client clearing industry which has been at a disadvantage since the introduction of the leverage ratio framework. While we support Option 3, we suggest extending its application to all derivatives and recommend that the Committee consider Option 4, described below, as the international standard.

<u>Recommended Option 4 – Alignment of Capital and Leverage Derivative rules</u>

While the leverage framework is meant to stop capital arbitrage, we believe that the capital and leverage ratio rules should be aligned for products such as derivatives and repos to ensure that both frameworks are reflecting the true risk (and not necessarily only the gross long positions as is the case with the leverage ratio rules). Implementing SA-CCR consistently under the capital and leverage ratio frameworks also provides operational benefits for firms.

We believe that all types of collateral for IM/VM should be acceptable not only with respect to client cleared derivatives but also for other types of transactions. We therefore recommend that the BCBS adopt Option 4 with SA-CCR implemented for all derivatives exposures regardless of

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[4] See Bloomberg article on Geneva Energy Markets (June 27, 2018): https://www.bloomberg.com/news/articles/2018-06-27/top-oil-market-maker-closes-after-damaging-regulatory-changes

whether there is client clearing or not. As mentioned, this approach has been implemented in Canada.

<u>Segregation of IM</u>

We do not believe that segregation of IM should be included as a criterion in the BCBS leverage ratio framework. We feel that it would be extremely difficult to establish a globally cohesive definition of “segregation” across jurisdictions. Moreover, there may be implications in terms of re-writing some CCP rules should there be a global requirement for legal certainty around the segregation of IM. We believe that segregation of IM should be defined by jurisdictional supervisors and based on bankruptcy and contagion effects.

Thank you in advance for considering our comments. We would be pleased to discuss our submission at your convenience.

Sincerely,

Cc: Brian Rumas, Managing Director, Bank Capital, Capital Division, OSFI
Catherine Girouard, Director, Bank Capital, Capital Division, OSFI
Patrick Tobin, Capital Specialist, Capital Division, OSFI
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