AFG's

Leverage ratio treatment of client cleared derivatives

Consultative Document issued by

the Basel Committee on Banking Supervision

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- Representing the business, financial and corporate interests of members, the entities that they manage (collective investment schemes) and their customers. As a talking partner of the public authorities of France and the European Union, the AFG makes an active contribution to new regulations,
- Informing and supporting its members; the AFG provides members with support on legal, tax, accounting and technical matters,
- Leading debate and discussion within the industry on rules of conduct, the protection and economic role of investment, corporate governance, investor representation, performance measurement, changes in management techniques, research, training, etc.
- Promoting the French asset management industry to investors, issuers, politicians and the media in France and abroad. The AFG represents the French industry – a world leader – in European and international bodies. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA), of PensionsEurope and of the International Investment Funds Association (IIFA).

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Derivatives can be part of the investment strategy in portfolios mainly as a way to reduce risk through hedging but also as a mean to gain exposure in the most efficient way, in particular when considering liquidity and cost.

AFG supports the legislator's objectives to designing a robust framework to reduce systemic risks and contribute to financial stability. Under EMIR in Europe, mandatory clearing has been set as one key pillars to achieve this overarching objective. A vast majority of French asset managers, which have access to CCPs, are acting through Clearing Members and very few of them have the capacity to become a direct member of a CCP. Consequently, the possibility for asset managers to access CCPs via their Clearing Members in good conditions is key.

Contractual framework between client and clearing members is biased towards clearing members[1]. In particular, clearing members are using their position to add contractual clauses that increase systemic risk and costs. Large institution have negotiated those contracts and are still dissatisfied and smaller institutions have even worse contracts.

Among these, we see the following:

- Ability to cancel unilaterally the trades. Ability to refuse collateral that even the CCP accepts
- Ability to unilaterally increase fees
- Operational burden like intraday posting which investor cannot perform
- Ability to ask for additional margin or haircuts on top of what the CCP requests

Market participants are concerned that clearing activity is not seen as key for investment banks as they consider leverage ratio treatment penalizes their activity. Small asset managers hardly find clearing members to support their activities. Large asset managers are forced to concentrate their activities with a very small number of Clearing Members.

Current methodology used to determine the leverage ratio, although simple and transparent, does not account for risk reduction benefits of margins posted to clearing members by clients. Double counting of offsetting risk exposures disproportionately affects clearing prices for end users and creates market

[1] An illustration of this bias is shown in latest FSB survey on incentive to clear: around 65% of clients estimate that they need more than 4 month to setup new contractual relationship with a clearing member while 87% of clearing members have the ability to terminate client-clearing services within 3 months.

access distortions between market participants that have access to CCPs as clearing members and others.

Overall, current leverage ratio treatment goes against regulators objective to to incentivize central clearing and the overarching objective of financial stability.

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In this document, we do not comment on the proposed changes to the leverage ratio formula. However, AFG welcomes and supports the Basel Committee's initiative to propose *"revisions to leverage ratio standard text to implement client initial margin offset of potential future exposure for client cleared derivatives"* as well as *"revisions to leverage ratio standard text to implement use of unmodified SA-CCR to measure exposures to client cleared derivatives".* We have a clear preference for the option that will allow to recognize both initial, and variation margins as offsetting risks, as potential losses and replacement costs related to cleared transactions are already secured by these collateral arrangements.

We believe there is no need for additional capital to be required to secure transactions for which collateral and margins provided already cover counterparties default and replacement risks.

In addition, with respect to Initial Margin, we consider that cash should not be privileged over government bond collateral. Cash can never be segregated. Giving incentive to cash over government bond collateral would increase overall market exposure to banking risk. Both Dodd Franck and EMIR allow Initial Margins to be posted in government bonds. Leverage Ratio regulation should not implicitly restrict such capacity by applying more favorable treatment for cash.

Consequently, we do believe that government bond segregated initial margins should be recognized for the purpose of calculating leverage ratio, in order to avoid penalizing significantly long term investors.

From our first discussions on EMIR, we have expressed the view that the issue of segregation was of utmost importance when considering financial stability. We advocated that CCPs and Clearing Members should, as required, propose Individual Segregation Arrangements (ISA), at reasonable cost, to allow for effective porting capacity when needed, and in particular in case of severe crisis to avoid chain defaults. We even made clear that in theory LSOC did not provide similar level of protection in case of default of the Clearing Member. Our concern that ISA would be difficult to implement at a reasonable cost is confirmed. Market participants can be charged on a per account basis for ISA, both at Clearing Member and CCP level. Segregation in the books of the CCP gives to the end client a direct contact with the CCP that is in a position to identify and monitor its positions independently from those of its Clearing Member. For an asset manager the segregation of its margins away from the own account of the Clearing Member (as suggested in the consultation document) is key and we support proposed requirement to segregate clients' accounts from own accounts trades.

With respect to re-use of collateral by the bank, neutralization of re-used collateral in the calculation of the leverage ratio should be allowed when the collateral posted by the end client aims at being transferred to the CCP only.