



July 6, 2016

Via Electronic Submission

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Re: Response to Basel Leverage Ratio Consultation Regarding the Proposed Calculation of Centrally Cleared Derivatives Exposures Without Offset for Initial Margin and its Impact on the Client-Clearing Business Model

Dear Sirs and Madams:

Members of FIA¹ appreciate the opportunity to comment on the Basel Committee's April 2016 Consultative Document: "Revisions to the Basel III Leverage Ratio Framework" (the "Proposal").² As the Proposal acknowledges, FIA and other market participants have voiced strong concerns that the failure of the Basel III Leverage Ratio Framework ("Basel Leverage Ratio") to recognize the exposure-reducing effect of initial margin in cleared derivatives transactions will have a significantly negative effect on the ability of bank or bank-affiliated clearing members to provide client clearing services. Our members believe that this in turn will result in significantly reduced services; higher fees for cleared derivative clients; increased concentration among clearing members; and reduced portability of client accounts in times of systemic stress – all of which would conflict with the G20 mandate to increase the use of central counterparty ("CCP") clearing for derivatives transactions.

The Proposal sets forth a modified version of the Standardized Approach for Counterparty Credit Risk ("SA-CCR") to measure derivatives exposures that would not include an offset to recognize the exposure-reducing effect of initial margin in cleared derivatives transactions. However, the Proposal notes that an offset is still under consideration for inclusion in the final revisions to the Basel Leverage Ratio, and includes a request for additional information regarding the effects of the Basel Leverage Ratio on client clearing. Accordingly, this comment letter provides such additional information.

¹ FIA is a global organization with offices in the US, Europe and Asia. Its core members, many of which are banking organizations, are members of central counterparties. FIA's membership also consists of the major global futures exchanges, clearinghouses, trading platforms, and others that, together, make central clearing possible.

² Basel Committee on Banking Supervision, Revisions to the Basel III Leverage Ratio Framework – Consultative Document (Apr. 2016), available at <http://www.bis.org/bcbs/publ/d365.htm>.

Part I of this letter provides an executive summary of our comments.

Part II provides and summarizes data collected by certain FIA members that are subject to the Basel Leverage Ratio to determine the effects of that ratio on their ability to clear their clients' derivatives. This data aggregates the leverage exposure that would be required under SA-CCR for client-cleared over-the-counter ("OTC") derivatives and exchange-traded derivatives ("ETD") based on client cleared derivatives positions as of the end of the fiscal year 2015 at 14 of the largest clearing members, holding \$131 billion in aggregate money, securities, and property for futures and options clients as of March 31, 2016. The data does not include the clearing members' proprietary positions or non-cleared derivatives.

Part III of this letter briefly summarizes why an offset is fully consistent with the fundamental principles of the Basel Leverage Ratio.

I. Executive Summary

The data collected clearly shows that the Basel Leverage Ratio's failure to include an offset for initial margin in the SA-CCR calculation ("SA-CCR-without-offset") would have the following consequences:

- (1) SA-CCR-without-offset would substantially increase clearing members' total leverage exposure compared to what it would be if the offset were included in the SA-CCR calculation ("SA-CCR-with-offset");
- (2) SA-CCR-without-offset would result in no difference in leverage exposure for clearing ETD compared to the leverage exposure as calculated under the Basel Leverage Ratio's existing calculation method, the Current Exposure Method, which also fails to include an offset for initial margin ("CEM-without-offset");
- (3) When compared to the existing CEM-without-offset, SA-CCR-without-offset would substantially increase clearing members' leverage exposure for certain clients using derivatives to hedge their economic risks, such as asset managers, insurance companies, and sovereigns; and
- (4) Like CEM-without-offset, SA-CCR-without-offset would result in substantially lower leverage-driven return on equity ("ROE")³ from clearing compared to SA-CCR-with-offset, producing ROE that would be well below even the most conservative ROE targets; this artificially depressed ROE would make it significantly more difficult for clearing members to continue to offer clearing services to clients.

As a result, our data supports the conclusion that, if uncorrected, the Proposal's artificial inflation of clearing members' leverage exposure would significantly reduce clearing

³ Based on a Basel Leverage Ratio calibrated at 5 percent.

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members' incentives to continue to offer clearing services for clients. This is particularly the case for the client portfolios that would produce the highest leverage exposure (*i.e.*, asset managers, insurance companies, and sovereigns), which, perversely, would tend to be the portfolios of clients that are the *least* prone to default; that use derivatives for risk management rather than speculation; and that pay the least amount of fees due to the low frequency of their transactions.

In turn, if adopted in the final standard, SA-CCR-without-offset:

- is likely to further reduce the number of clearing members in the market;
- is likely to impair the liquidity and portability of clients' derivatives portfolios, particularly in times of crisis, therefore increasing systemic risk;
- would reduce access to cleared derivatives for clients, particularly those that result in disproportionately high leverage exposures (*i.e.*, asset managers, insurance companies, and sovereigns);
- would increase costs for clients, including energy, commodities, and agricultural clients; and
- is likely to substantially reduce the incentives of banking organizations to invest in the clearing business.

These problems will only be exacerbated as clearing mandates come into effect globally.

Furthermore, an offset is fully consistent with the fundamental principles of the Basel Leverage Ratio and the clear policy to support central clearing, *i.e.*, –

- that leverage capital should only be held against ***actual economic exposure***;
- that the client's segregated and liquid initial margin always absorbs losses ***before*** a clearing member absorbs losses related to the client's transaction with a central counterparty, and therefore should be viewed as ***exposure-reducing***;
- that recognition of an offset for initial margin in the ***off-balance sheet*** context is justified despite the fact that traditional leverage ratios generally have not recognized an offset for collateral in the ***on-balance sheet*** context – traditional leverage ratios generally follow balance-sheet accounting principles to determine on-balance sheet assets, but no such principles apply in the off-balance sheet context, where actual economic exposure is the governing principle; and
- that the failure to recognize the exposure-reducing effect of segregated margin would create disincentives to engage in client-cleared transactions that would be fundamentally at odds with the G20 mandate to promote central clearing and exchange trading.

II. SA-CCR-Without-Offset Would Result in Substantially Higher Leverage Exposures for Client-Cleared Derivatives Transactions than SA-CCR-With-Offset

The Proposal states that its proposed version of SA-CCR will allow centrally cleared derivative exposures to be calculated with a five-day margin period of risk (“MPOR”), which will result in a significant decrease in clearing members’ Potential Future Exposure (“PFE”) and therefore “provid[es] incentives to support the use of client clearing.” The Proposal further states that, in contrast, “potential recognition of offsets of [initial margin] against PFE in line with the unmodified SA-CCR calculation would not further decrease the amount of [clearing members’] PFE substantially.” Contrary to these statements, our data strongly supports the opposite conclusion, as shown in the charts set forth below. That is, the data demonstrates that our members’ total leverage exposure under SA-CCR-without-offset would be **substantially greater** than under SA-CCR-with-offset; as a result, recognizing the offset would clearly provide the types of “incentives to support the use of client clearing” that the Proposal points to with respect to MPOR. (Each clearing member determined offset amounts for calculating SA-CCR-with-offset as the offset allowed by the margin multiplier formula in the Basel SA-CCR framework, rather than a full one-to-one offset for each dollar of initial margin received.⁴)

In addition, the data demonstrates that, even when compared to the existing CEM-without-offset, SA-CCR-without-offset (1) has essentially no effect on total leverage exposure for ETD in the aggregate, thereby providing no “incentives to support client clearing” and (2) results in materially higher leverage exposure for certain categories of clients, thereby creating **disincentives** to “support client clearing.”

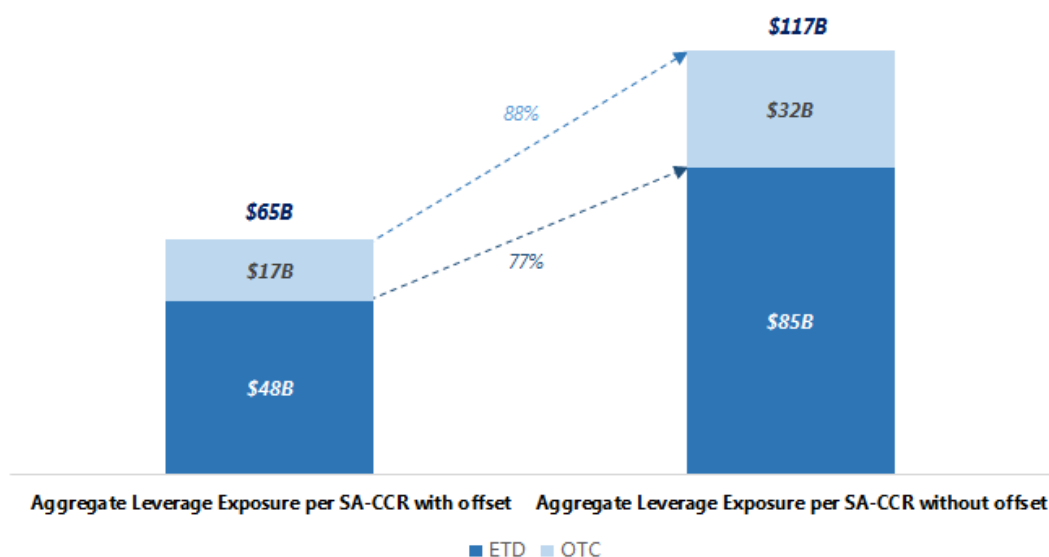
Finally, the data show that clearing members’ ROE under SA-CCR-without-offset would be significantly lower than under SA-CCR-with-offset (even though ROE for clearing under the latter would remain significantly lower than for other lines of business) – and that lower ROE would also fail to “provide incentives to support client clearing.”

⁴ See Basel Committee on Banking Supervision, the Standardized Approach for Measuring Counterparty Credit Risk Exposures, at ¶ 149 (Mar. 2014; rev. Apr. 2014), available at <http://www.bis.org/publ/bcbs279.htm>.

A. Aggregate Leverage Exposure Under SA-CCR Is Significantly Higher When Initial Margin is Not Recognized

As depicted in Figure 1 below, the **aggregate** leverage exposure of the 14 participating firms would be **80 percent higher** under SA-CCR-without-offset as compared to SA-CCR-with-offset⁵ – plainly a significant difference. Moreover, this difference would be significant for the leverage exposure attributed to **both** OTC derivatives clearing, which would be 88 percent higher under SA-CCR-without-offset than SA-CCR-with-offset, **and** ETD clearing, which would be 77 percent higher.

Figure 1 - Difference in Aggregate Leverage Exposure Under SA-CCR When Initial Margin is Not Recognized



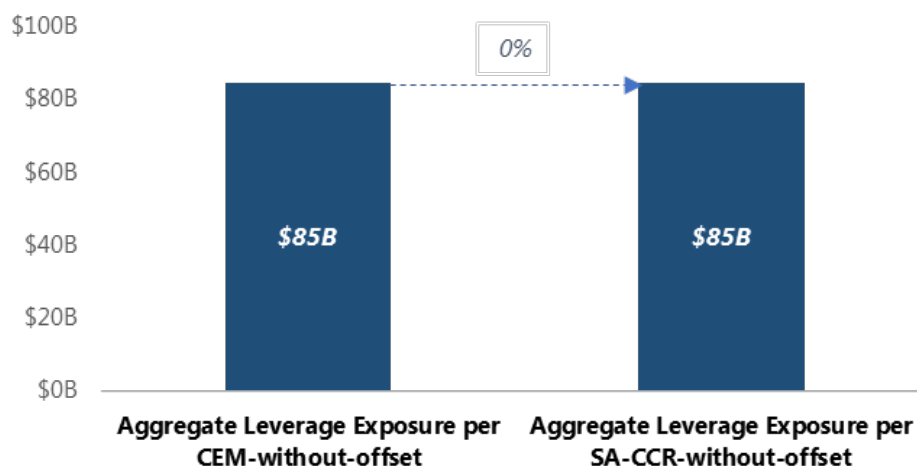
⁵ As used in this letter, “leverage exposure” means exposures arising from derivative transactions as calculated under SA-CCR or CEM, as applicable, and does not include the assets that can arise from the receipt of cash initial margin.

B. SA-CCR-Without-Offset Does Nothing to Remove the Disincentive to Engage in ETD Clearing Created by CEM-Without-Offset

Figure 2 below shows that, with respect to ETD clients, there would be **no difference** in aggregate leverage exposure between SA-CCR-without-offset and CEM-without-offset. Stated differently, SA-CCR-without-offset would do **nothing** to dampen the seriously negative impact that the existing Basel Leverage Ratio standard, which uses CEM-without-offset, has already had on clearing members with respect to ETD products. Thus, contrary to the Proposal's statements, the adoption of a five-day MPOR and other changes to the calculation of PFE will not "provide incentives to support client clearing" of ETD products. Leverage exposure for clearing ETDs would not change in the aggregate under SA-CCR-without-offset compared to CEM-without-offset for a variety of reasons.⁶

This result is troubling given the G20 commitment that has encouraged or required trading of derivatives on exchanges and the resulting migration of formerly OTC products onto exchanges, which is expected to continue. In contrast, if SA-CCR-with-offset were adopted, it would significantly reduce leverage exposure for ETD as compared to CEM-without-offset, thereby creating further incentives to support client clearing, consistent with regulatory policy supporting the migration to centrally cleared products.

Figure 2 - Difference in Leverage Exposure for ETD Clearing



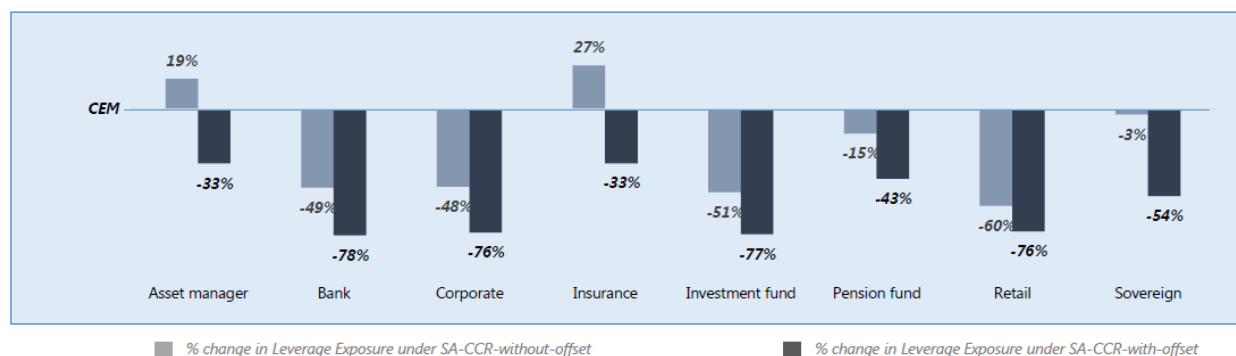
⁶ Although ETD portfolios benefit from the risk-offsetting nature of the SA-CCR PFE calculation, these savings are fully offset in aggregate by other components of the SA-CCR calculation that cause ETD products to be treated more punitively under SA-CCR vs CEM. The factors that are detrimental to ETD products' treatment under SA-CCR include the supervisory duration multiplier applied to listed interest rate products, the punitive treatment of clients using ETD products to hedge their exposures (pension funds, corporates, and insurance funds), as well as the 1.4x SA-CCR scaling factor that does not exist under CEM.

C. Clients That Are Least Prone to Default And Most Likely to Use Cleared Derivatives for Risk Management Will Generate Higher Leverage Exposure Under SA-CCR-Without-Offset Than Under CEM-Without-Offset

Figure 3 below depicts the change in aggregate leverage exposure for participating firms' clearing of *all* derivatives – both ETD and OTC – for different types of clients. For each type of client, it uses the existing Basel Leverage Ratio calculation of leverage exposure using CEM-without-offset as the baseline (represented as the horizontal axis), and it then shows the differences in leverage exposure that would be produced by SA-CCR-without-offset and SA-CCR-with-offset (both along the vertical axis).

Notably, for some types of clients, SA-CCR-without-offset produces a significantly higher leverage exposure than is the case under the existing Basel Leverage Ratio calculation of CEM-without-offset. Specifically, clearing for asset managers and insurance companies would produce substantially worse results under SA-CCR-without-offset than under CEM-without-offset. In other words, it would be *even more* challenging for clearing members to clear for these clients in the future under SA-CCR-without-offset than it is today under the existing Leverage Ratio standard.

Figure 3 - Difference in Aggregate Leverage Exposure For Clearing All Derivatives (ETD and OTC), By Client Type



With respect to ETD transactions only, clearing for asset managers, insurance companies, and especially sovereigns would be significantly more punitive under SA-CCR-without-offset than CEM-without-offset. Specifically, clearing members' leverage exposure for clearing ETD would be 16 percent greater for asset manager clients, 47 percent greater for insurance clients, and an extraordinary **139 percent** greater for sovereign clients. Those disparities would be substantially mitigated by the adoption of SA-CCR-with-offset. In addition, there would be no change in leverage exposure for clearing ETD for pension funds under SA-CCR-without-offset compared to CEM-without-offset. Moreover, we believe the Proposal would result in disproportionately large leverage exposure for energy, commodity, and agricultural clients that use ETD products for hedging .

Similarly, with respect to OTC transactions only, clearing for asset managers, corporate clients, and insurance companies would be more punitive under SA-CCR-without-offset than CEM-without-offset. Specifically, clearing members' leverage exposure for clearing OTC derivatives would be 24 percent greater for asset manager clients, 7 percent greater for

corporate clients, 1 percent greater for insurance clients, and no different for retail clients. As with ETD, the OTC disparities would be substantially mitigated by the adoption of SA-CCR-with-offset. In addition, there would be no change in leverage exposure for clearing OTC derivatives for retail clients under SA-CCR-without-offset compared to CEM-without-offset.

The clients that would be most adversely affected by the proposed SA-CCR-without-offset – asset managers, insurance, corporates, pension funds, retail, and sovereigns – are the clients that generally use cleared derivatives solely for risk management purposes and not speculation. While these clients use cleared derivatives to reduce their economic risks, clearing members are generally only exposed to the hedge, which is directional and therefore results in disproportionately high leverage exposure under the Basel Leverage Ratio. These clients also tend to be lower-revenue clients for clearing members because they enter into transactions less frequently than hedge funds and other investor clients. Moreover, adverse impacts on these types of clients have the most spillover to the real economy, ultimately affecting consumers, workers, taxpayers, and retail investors.

D. Already Depressed ROE Would Be Lower Under SA-CCR-Without-Offset Than Under SA-CCR-With-Offset

Due to the substantially higher leverage exposure under SA-CCR-without-offset, FIA data shows that SA-CCR-without-offset produces lower aggregate ROE for the clearing business than SA-CCR-with-offset. Even under SA-CCR-with-offset, ROE would be below even the most conservative ROE targets for financial institutions or their individual lines of business. As a result, under the proposed standard banking organizations will be strongly incentivized to allocate a greater amount of capital to business lines with better capital-adjusted returns than derivatives clearing for clients, even when those business lines in fact entail more risk.

Under SA-CCR-without-offset, aggregate ROE would be 25 percent lower than under SA-CCR-with-offset – which would itself be very modest and lower than most clearing members' ROE targets. Thus, adopting an offset for initial margin would not produce a windfall for clearing members, but it would remove an unnecessary constraint that causes ROE to be artificially depressed.

* * *

In sum, the data demonstrates clearly that SA-CCR-without-offset would in fact produce much higher leverage exposure and much lower ROE than SA-CCR-with-offset. In addition, the data shows that SA-CCR-without-offset would create disparate results for different types of clients, especially in relation to the existing CEM-without-offset calculation. None of these results is warranted given the plainly exposure-reducing effect of initial margin – and more to the point, the failure to recognize such exposure-reduction would needlessly produce significantly adverse consequences:

- ***Reduction in Number of Clearing Members.*** Since the introduction of the Basel Leverage Ratio, there has been a substantial reduction in the number of clearing members. For example, in the last two years, the number of futures commission

merchants (“FCMs”) offering client clearing services in the United States has fallen over 20 percent (from 69 to 55).⁷ Over the past 10 years, the number of FCMs has fallen by almost 40 percent (from 90 to 55). With artificially low average ROE for clearing under the Proposal, more banking organizations may choose simply to exit the clearing business and instead deploy any excess balance sheet capacity to businesses with greater capital-adjusted returns. As a result, there would be even fewer clearing members in the market. We do not believe non-bank-affiliated entities would be able to fill the void in clearing volume, given the very large fixed costs, margin requirements, and regulatory compliance obligations inherent in the business of derivatives clearing. Indeed, non-bank-affiliated entities have not entered the market in response to the exits that have already occurred.

- ***Increase in Systemic Risk from Barriers to Portability of Cleared Derivatives.*** Under SA-CCR-without-offset, clearing members would be reluctant to accept client positions from a failed or distressed clearing member, as IOSCO and other regulatory bodies have noted – especially in times of systemwide stress.⁸ During periods of market stress, when CCP margin requirements increase, and when availability of bank capital declines, portability will be more difficult as less capital is available to accept the cleared derivative portfolios from other clearing members, including distressed banks. Without the ability to transfer client positions in an orderly manner, a CCP would be forced to liquidate the positions of clients’ of a failed or distressed clearing member, creating a strain on the market, market losses for clients, and losses of clients’ hedge positions, which would increase risk in the real economy. In addition, as the levels of margin required by CCPs increase in times of stress, leverage ratio capital costs would correspondingly increase, aggravating the constraint on portfolio purchases. Any liquidation in positions due to the inability to port the positions to a new clearing member would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.
- ***Reduction in Access for Clients.*** Since the introduction of the Basel Leverage Ratio, clearing members have continually reevaluated their client relationships with the goal of minimizing leverage exposure. With artificially low ROE under the Proposal, clearing members would be even less likely to work with clients that present the greatest leverage exposure, instead choosing to clear fewer transactions for such clients. The data shows that clearing members will be disincentivized to provide clearing services to clients that have directional portfolios, such as asset managers, corporates, insurance companies, and

⁷ See U.S. Commodity Futures Trading Commission, Financial Data for FCMs, <http://www.cftc.gov/MarketReports/FinancialDataforFCMs/index.htm>.

⁸ See, e.g., U.S. Commodity Futures Trading Commission Chairman Timothy G. Massad, Remarks Before CCP12 Founding Conference and CCP Forum, Shanghai, China (June 7, 2016), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-46> (“[C]learing members may be reluctant or unable to take on the customers of a defaulting clearing member, or to bid for positions in an auction, even though those positions are accompanied by suitable margin to mitigate default risk, because that margin is not credited against its leverage ratio. That could increase the risk arising from the default, in what could already be a stressed market.”).

sovereigns. These clients use derivatives to hedge their underlying economic risks, and could be limited in their ability to do so due to a lack of capacity in the market. Indeed, these clients have **already** experienced reduced access under CEM-without-offset, even though the Leverage Ratio is not yet a binding requirement in all jurisdictions.⁹ SA-CCR-without-offset will, if anything, only incentivize clearing members to provide clearing services to clients that move in and out of the market and do not build up large positions over time.

- **Increase in Costs for Clients.** Similarly, an increase in required capital (and decrease in ROE) for clearing – as would result under the Proposal – would cause a further increase in prices for clients. Price increases would force clients to reconsider their willingness to hedge their economic risks, which could result in an increase in risk in the real economy.
- **Reduction in Investments in Clearing Businesses.** With an artificially low ROE for clearing under the Proposal, banks will be less likely to be able to invest in the technology, systems, and people that make cleared derivatives markets work well for their clients.

These negative impacts on the market can be avoided or substantially mitigated if the final revision to the Leverage Ratio Framework recognizes an offset to clearing members' PFE for segregated initial margin provided in client-cleared derivatives transactions.

III. SA-CCR-With-Offset Would Be Fully Consistent With the Principles Underlying the Basel Leverage Ratio

FIA strongly believes that an offset for initial margin is fully consistent with the fundamental principles underlying the Basel Leverage Ratio. The key reasons for this are—

- The total leverage exposure in the denominator of the Basel Leverage Ratio is intended to capture a clearing member's **actual economic exposure** to losses that could arise from its client clearing activities.
- Client initial margin that is required to be segregated and highly liquid is always available to absorb losses from a client's exposure to a CCP **before** a clearing member absorbs any losses related to that client's transaction with the CCP. In effect, segregated initial margin is a prepayment of the clearing member's PFE, which makes clearing fundamentally a very low-exposure activity. Indeed, even during the June 2016 market volatility, none of the participating firms suffered a loss due to the default of a client from the provision of client clearing services.

⁹ See SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers (Feb. 1, 2016), *available at* <http://www.sifma.org/issues/item.aspx?id=8589958563>.

- As a result, the total leverage exposure of the clearing member to the CCP arising from the clearing member's guarantee of the client's obligation to the CCP should always reflect the exposure-reducing effect of initial margin.
- Such a result is justified despite the fact that traditional leverage ratios generally have not recognized the exposure-reducing effect of collateral. Traditional leverage ratios have only concerned **on-balance sheet** assets and in that context have generally followed accounting principles to determine what qualifies as an asset – and in the on-balance sheet context, accounting principles do not generally treat collateral like margin as reducing the value of an asset. In contrast, client-cleared derivatives exposures under the Basel Leverage Ratio are an **off-balance sheet** construct that are not governed by accounting principles but are instead intended to reflect actual economic exposure as determined by regulators. In that context, it is totally appropriate for the Basel Leverage Ratio to recognize the exposure-reducing effect of initial margin.
- The failure to recognize the exposure-reducing effect of segregated margin would be fundamentally at odds with the G20 mandates to promote central clearing and exchange-trading of derivatives since, as described in this letter, the proposed migration to SA-CCR-without-offset will seriously disincentivize derivatives clearing in general and ETD clearing in particular.

Each of these points is explained and supported in detail in FIA's previous comment letters to the Committee, which are included with this letter as Appendices A and B.

* * *

We stand ready to provide more detailed data to the Committee upon request, and would be pleased to discuss this letter and our data with the Committee and its members. If you have any questions or need additional information, please contact Jacqueline Mesa, Senior Vice President, Global Policy, FIA, at 1 202-772-3040 or jmesa@fia.org.

Sincerely,



Walter L. Lukken
President and Chief Executive
Officer
FIA

Appendix A

FIA Global's November 18, 2014 Letter to the Basel Committee on Banking Supervision



November 18, 2014

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Re: **Treatment of segregated margin in the calculation of
centrally cleared derivatives exposures under the Basel
III Leverage Ratio**

Dear Sirs and Madams:

This letter sets forth the reasons why the undersigned global trade associations and central counterparties (“Global Trade Associations and CCPs”) strongly believe that, in the context of a bank exposure created by a cleared derivatives transaction, the Basel III leverage ratio should recognize the exposure-reducing effect of margin that is **segregated**, because segregated margin cannot be used to increase the bank’s leverage. In particular, and as described in more detail below, if and when the Basel Committee on Banking Supervision (the “BCBS”) adopts the standardized approach for measuring counterparty credit risk exposures (“SA-CCR”) in the leverage ratio context as a replacement for the Current Exposure Method (“CEM”) for measuring such exposures—which we strongly support—it would be extremely important to recognize the exposure-reducing effect of segregated margin on cleared derivatives exposures.

The Global Trade Associations and CCPs consist of FIA Global, World Federation of Exchanges, CCP12, ICE, CME Group, LCH Clearnet Group, and Eurex Group. FIA Global, the alliance of FIA, FIA Europe and FIA Asia, is the primary global industry association for centrally cleared futures, options, and swaps. Its core members, many of which are banking organizations, are members of central counterparties (“CCPs”). FIA’s membership also consists of the major global futures exchanges, clearinghouses, trading platforms, and others that, together, make central clearing possible. The World Federation of Exchanges (“WFE”) is the global association representing the interests of 64 publicly regulated stock, futures, and options exchanges, as well as the CCPs that many of these exchanges operate. CCP12 is the global association of CCPs consisting of over 50 CCPs from all over the world.

I. Background

Earlier this year, the BCBS issued the *Basel III leverage ratio framework and disclosure requirements*, which sets forth the leverage ratio that will operate as a backstop to the risk-based capital standard (the “leverage ratio”).¹ While the leverage ratio is a final standard for reporting purposes, the BCBS has issued answers to “Frequently Asked Questions” or “FAQs” in order to address interpretive questions that have arisen during the implementation of the leverage ratio.² In addition, the BCBS has begun considering adjustments to the calibration and other aspects of the leverage ratio as the standard moves from a reporting-only requirement to a minimum capital requirement by the end of 2018. In this context, the Global Trade Associations and CCPs submit this letter regarding the appropriate treatment of segregated margin for exposures arising out of centrally cleared derivatives transactions, one of the key issues for our members.

We recognize that the leverage ratio has been adopted as a backstop to the risk-based capital ratio. It is critical, however, that the denominator of the leverage ratio—the “total leverage exposure”—accurately capture the actual off-balance sheet exposures that a banking organization has to its counterparties, including exposures arising out of centrally cleared derivatives transactions. In this regard, the Global Trade Associations and CCPs are deeply concerned about the failure of the leverage ratio to recognize the exposure-reducing effect of segregated margin in the limited context of centrally cleared derivatives transactions (whether executed over-the-counter or through an exchange).³ Unlike margin posted in many uncleared derivatives transactions, margin that is segregated—as is very often the case for cleared derivatives transactions—may **not** be leveraged by a bank.⁴ As a result, such segregated margin is solely exposure-reducing with respect to a bank’s cleared derivatives exposure, and

¹ Basel Committee on Banking Supervision, *Basel III leverage ratio framework and disclosure requirements* (Jan. 12, 2014), available at <http://www.bis.org/press/p140112a.htm>.

² Basel Committee on Banking Supervision, *Frequently asked questions on the Basel III leverage ratio framework* (Oct. 7, 2014), available at <http://www.bis.org/publ/bcbs293.htm>.

³ As used in this letter, “segregated margin” refers to margin—other than variation margin—that is provided to a clearing member but cannot be used by that member to leverage itself due to national laws, regulatory/client money rules or clearinghouse requirements that prevent clearing members from using posted collateral for purposes other than collateralising client exposure, including, for example, rules issued by the Commodity Futures Trading Commission, e.g., 17 C.F.R. §§ 1.20-1.30 (futures) and 17 C.F.R. §§ 22.2- 22.7 (cleared swaps), and rules issued under the UK Client Asset Sourcebook (“CASS”) regime, e.g., CASS 7.3.1R and CASS 7.4.1R. Segregated margin usually consists of initial margin.

⁴ Segregated margin typically can be invested only in bank deposits or very conservative, highly liquid investments; as a result, it cannot be used by the clearing bank to truly leverage itself through loans or high risk investments. See, e.g., 17 C.F.R. § 1.25; see also *infra* note 12.

accordingly, we strongly believe that the leverage ratio's total leverage exposure ought to recognize that reduction. Furthermore, as described in more detail below, a failure to recognize the exposure-reducing effect of segregated margin will have materially adverse consequences on cleared derivatives markets, end users, and market participants.

Accordingly, Part II of this letter summarizes the leverage ratio's failure to recognize the exposure-reducing effect of segregated margin in the calculation of derivatives exposures, including the potentially compounding effect of the leverage ratio's treatment of such margin received in the form of cash; it also explains why the stated policy rationale for this lack of recognition does not apply in the context of segregated margin for centrally cleared derivatives exposures. Part III describes the likely adverse effects of the failure to recognize the exposure-reducing effect of segregated margin on cleared derivatives markets and market participants, as well as the inconsistency of this failure with the global policy to promote centralized clearing agreed to at the Pittsburgh G20 Summit in 2009. Finally, Part IV describes several alternatives that we believe the BCBS should consider in order to recognize the exposure-reducing effect of segregated margin on cleared derivatives exposures in the leverage ratio, especially in the context of its consideration of the replacement of CEM with SA-CCR for purposes of calculating derivatives exposures.

II. The Leverage Ratio's Failure to Recognize the Exposure-Reducing Effect of Segregated Margin in the Calculation of Cleared Derivatives Exposures

The leverage ratio generally adopted the CEM to capture off-balance sheet derivatives exposures, including centrally cleared derivatives exposures, in its measure of total leverage exposure.⁵ In the risk-based capital context, the CEM is used to calculate an institution's potential future exposure ("PFE") with respect to derivatives exposures, and the PFE calculation recognizes the exposure-reducing effect of margin.⁶ While the leverage ratio

⁵ See leverage ratio, ¶ 19 n.5.

⁶ Indeed, in the risk-based capital context, the BCBS has repeatedly recognized the exposure-reducing effect of margin. See, e.g., *Capitalisation of bank exposures to central counterparties* (Nov. 2011), available at <http://www.bis.org/publ/bcbs206.htm>; *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* (Feb. 2013), available at <http://www.bis.org/publ/bcbs241.htm>; *Capital treatment of bank exposures to central counterparties* (June 2013), available at <http://www.bis.org/publ/bcbs253.htm>; *The non-internal model method for capitalising counterparty credit risk exposures* (June 2013), available at <http://www.bis.org/publ/bcbs254.htm>; *Margin requirements for non-centrally cleared derivatives* (Sept. 2013), available at <http://www.bis.org/publ/bcbs261.htm>; *The standardised approach for measuring counterparty credit risk exposures* (Mar. 2014; rev. Apr. 2014), available at <http://www.bis.org/publ/bcbs279.htm>; *Capital requirements for bank exposures to central counterparties* (Apr. 2014), available at <http://www.bis.org/publ/bcbs282.htm>; and *Supervisory framework for measuring and controlling large exposures* (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.htm>.

generally incorporated a CEM-based methodology to capture derivatives exposures, it differs from risk-based CEM in one critical respect: the leverage ratio's CEM approach does not permit margin to reduce derivative exposures—except for cash variation margin in certain circumstances⁷—with no distinction made between (1) derivatives exposures where the margin is not segregated, and (2) those cleared derivatives exposures where the margin is segregated: “As a general rule, collateral received may not be netted against derivative exposures whether or not netting is permitted under the bank's operative accounting or risk-based framework.”⁸

In articulating this sweeping “general rule,” the leverage ratio expressly acknowledges that margin collateral “reduces counterparty exposure,” but that it can also have a countervailing effect: “it can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.”⁹ As a result, the leverage ratio states, “[c]ollateral received in connection with derivative contracts does not necessarily reduce the leverage in a bank's derivatives position, which is generally the case if the settlement exposure arising from the underlying derivative contract is not reduced.”¹⁰ Thus, the ability of a bank to leverage the margin collateral it receives from a derivatives counterparty is the **sole policy rationale** for concluding that “a bank must not reduce [a derivative] exposure amount by any collateral received from the counterparty.”¹¹

The Global Trade Associations and CCPs understand this policy rationale with respect to margin that is neither segregated for the client nor cash variation margin; such non-segregated margin can be re-hypothecated and leveraged for the benefit of the bank, as is currently the case with respect to initial margin posted in most uncleared derivatives transactions. But in the central clearing context, that rationale simply does not apply to margin that is segregated, because segregation by definition prohibits the bank from leveraging such collateral for its own benefit. When it is segregated for the client in this manner, margin received is solely exposure-reducing; it is not “at the disposal of the bank,” and the bank **cannot** “use the collateral to leverage itself.” As a result, where margin is segregated, the leverage ratio's policy rationale for not recognizing its otherwise exposure-reducing effect is inapplicable.

In practice, the margin posted in centrally cleared derivatives transactions is frequently segregated. For example, in the United States, rules established by the Commodity

⁷ Leverage ratio, ¶¶ 25-26.

⁸ Leverage ratio, ¶¶ 22-24.

⁹ Leverage ratio, ¶ 22.

¹⁰ Leverage ratio, ¶ 23.

¹¹ *Id.*

Futures Trading Commission require such segregation for all cleared derivatives transactions.¹² Similarly, in the United Kingdom, such segregation occurs with respect to clients that are provided money protection under the Client Asset Sourcebook (“CASS”).¹³ Indeed, whenever margin is “on-posted” to a derivatives clearinghouse or deposited with a third party, it is no longer in the control of the clearing member bank and cannot be used by that bank to leverage its activities. Accordingly, the Global Trade Associations and CCPs strongly believe that segregated margin posted in cleared derivatives transactions, which cannot be leveraged by the clearing member bank, ought to be recognized as exposure-reducing under the leverage ratio.

Moreover, the leverage ratio’s inappropriate treatment of segregated margin in cleared transactions is compounded where such margin is posted in the form of cash, rather than securities, as is often the case. The accounting rules of some jurisdictions require such segregated cash margin to be treated as an on-balance sheet asset of the receiving bank, and as such, the segregated cash is included as a separate leverage exposure in the denominator of the bank’s leverage ratio.¹⁴ In these circumstances, the bank is subject to a **double** leverage ratio penalty: (1) the segregated cash margin received may not be used to reduce a cleared derivatives exposure in the denominator of the bank’s leverage ratio, and (2) because such segregated cash margin is treated as an on-balance sheet asset, it must be separately added as an exposure to that denominator as well.

¹² 17 C.F.R. §§ 1.20-1.30 (futures); 17 C.F.R. §§ 22.2- 22.7 (cleared swaps). Under these rules, a bank must separately account for, and segregate as belonging to the client, all money, securities and property it receives from a client as margin. In addition, the bank may not use such segregated margin to support its own operations or re-invest the collateral except for investments in a narrow range of very low risk and highly liquid assets, such as U.S. government and municipal securities, managed “with the objectives of preserving principal and maintaining liquidity.” 17 C.F.R. § 1.25.

¹³ CASS 7.3.1R and CASS 7.4.1R.

¹⁴ See, e.g., 79 Fed. Reg. 57,725, 57,735 (col. 2-3), 57,742 (col. 1) (Sept. 26, 2014). Conversely, segregated margin received by a bank in the form of securities, rather than cash, is not treated as an asset on the balance sheet of the bank for accounting purposes, and as a result, is also not included as a separate exposure in the leverage ratio. See, e.g., 79 Fed. Reg. at 57,742 (col. 1). This differential leverage ratio treatment of cash margin and securities margin creates a perverse incentive for a bank to prefer the receipt of margin (other than variation margin) in the arguably riskier form of securities rather than cash. And where margin is provided in the form of cash, a bank would have another perverse incentive to take less margin than might be optimal for risk management purposes, since any cash margin received would increase the bank’s total exposure measure under the leverage ratio.

III. **Consequences of Excluding Margin in Measuring Derivative Exposures for Cleared Transactions**

If not clarified or amended, the failure of the leverage ratio to recognize the exposure-reducing effect of segregated margin—compounded in the case of such margin received as cash—will likely have seriously negative effects on cleared derivatives markets and market participants, including end users. The margin practices and requirements of centrally cleared derivatives markets make banks’ participation in the derivatives clearing business a lower risk activity, with appropriate risk-based capital requirements calibrated in the recently finalized standard for bank exposures to central counterparties.¹⁵ In this context, the failure to recognize the exposure-reducing effect of segregated margin for leverage ratio purposes will substantially and unnecessarily increase the amount of required capital that will need to be allocated to this business.

Such a significant increase in required capital will also significantly increase costs for end users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers. Further, banks may be less likely to take on new clients for derivatives clearing. As a result, market participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks.

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. That is, in times of market stress, when banks’ capital may decline to levels that make the leverage ratio a truly binding limit, the ability of such banks to purchase portfolios of cleared derivatives from other banks—including distressed banks—will be severely constrained. Moreover, as the levels of margin required by CCPs increase in times of stress, leverage ratio capital costs will correspondingly increase, aggravating the constraint on portfolio purchases. Such a constraint on providing liquidity to stressed markets would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.

Significantly increased capital costs will also likely result in market exit by some derivatives clearing members that will find the business no longer economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end user access to the risk mitigation benefits of central clearing.

¹⁵ Basel Committee on Banking Supervision, *Capital requirements for bank exposures to central counterparties* (Apr. 10, 2014), available at <http://www.bis.org/publ/bcbs282.htm>.

The consequences outlined above are fundamentally inconsistent with global policies designed to enhance the appropriate use of centrally cleared derivatives. The Pittsburgh G20 commitments of 2009 established a clear policy that mandatory clearing of certain derivatives is essential to improving risk management and promoting financial stability. The Dodd Frank Act (“DFA”) in the United States and European Market Infrastructure Regulation (“EMIR”) in Europe translated this policy into binding regulatory requirements. Unfortunately, if not amended, the leverage ratio will be plainly at odds with these commitments and requirements:

- DFA and EMIR are built on the assumption that there will be an adequate number of clearing members that are able to, and remain willing to, provide access to clearing houses for their direct and indirect clients, and that as a result, clearing members will significantly increase the number of clients for which they provide clearing services;
- The current treatment of segregated margin in the leverage ratio may discourage clearing members from working with clients that create a higher balance sheet and leverage ratio impact; clients that typically enter into long-dated, very directional derivatives transactions (such as pension funds and insurance companies, for example), fall into this category.

IV. Possible Ways to Recognize the Exposure-Reducing Effect of Segregated Margin on Cleared Derivatives Exposures

If the BCBS were to decide that, in the context of cleared derivatives transactions, exposures should be reduced by segregated margin, there would be at least three ways to achieve this result.

First, the BCBS could issue an FAQ document interpreting the current leverage ratio text to permit an exception to the “general rule” that prohibits the recognition of collateral as exposure-reducing in the context of derivatives transactions generally. As discussed above, the expressed policy rationale for this general prohibition is concern about collateral increasing the economic resources at the disposal of the bank, and thus, the ability of the bank to use collateral to increase leverage. Again, this policy concern is not present in the context of segregated margin provided in the context of cleared derivatives transactions. Where a clearing member bank is simply unable to leverage margin because it is segregated, the sole effect of the margin is to reduce exposure, not increase leverage. In addition, recognition of the exposure-reducing effect of segregated margin in the clearing context would avoid the negative consequences to the cleared derivatives market described above, which would be fully consistent with clear BCBS policies designed to foster centralized clearing of derivatives. Accordingly, an FAQ could clarify that, while the leverage ratio generally continues to prohibit the recognition of collateral reductions in derivatives exposures generally, that prohibition would not apply in the limited context of cleared derivatives transactions where the collateral takes the form of margin that is segregated so that it cannot be leveraged. In addition, the FAQ could also clarify that, for

the same reasons, segregated margin received in the form of cash should not be counted as an exposure in the denominator of a bank's leverage ratio, even if treated as an on-balance sheet asset under the particular accounting regime applicable to that bank.

Second, the BCBS could amend the text of the leverage ratio to expressly recognize the exposure-reducing effect of segregated margin in the context of cleared derivatives exposures. While the amended text of the leverage ratio was finalized just last January, the Committee has made clear that it will soon be revisiting that text in the context of considering a recalibration of the leverage ratio, as well as in the context of finalizing the leverage ratio as a minimum capital requirement. While the Global Trade Associations and CCPs do not believe that it is necessary to amend the text to achieve recognition for segregated margin, or the exclusion from total leverage exposure of segregated margin received in the form of cash, such an amendment would be appropriate if the BCBS decided not to adopt the FAQ interpretive approach.

Third, we note that, even as the BCBS adopted the modified version of the CEM in the final leverage ratio in January of 2014, it stated that it was considering alternatives to replace CEM in the risk-based context, and that, if an alternative calculation methodology were adopted in that context, the Committee would then consider whether a similar alternative approach would be appropriate in the leverage ratio context.¹⁶ In March and April of 2014, the BCBS did indeed adopt an alternative calculation methodology to replace CEM in the risk-based context: SA-CCR. SA-CCR is a considerably improved alternative to CEM as it recognizes the benefit of collateral and netting agreements and appropriately differentiates between margined and unmargined trades; in the risk-based context, SA-CCR also expressly recognizes the exposure-reducing effect of margin. The Global Trade Associations and CCPs understand that the BCBS is now considering whether SA-CCR should replace the CEM approach used to calculate derivatives exposures in the leverage ratio. We strongly believe that replacing CEM with SA-CCR in the leverage ratio context would be just as much an improvement as it is in the risk-based context. In addition, we believe that any process to modify the leverage ratio to incorporate SA-CCR would also present an appropriate opportunity—and perhaps the best and most logical opportunity—for the extremely important recognition of the exposure-reducing effect of segregated margin on cleared derivatives exposures.

Finally, we strongly urge the BCBS to undertake a Quantitative Impact Study on the treatment of cleared derivatives transactions under the leverage ratio.¹⁷ In this context, we

¹⁶ Leverage ratio, ¶ 19 n.5.

¹⁷ The OTC Derivatives Assessment Team (OTC DAT), comprised of members of the Financial Stability Board and the BCBS, recently concluded that “quantitative analysis indicate that clearing member banks (ie those institutions that clear directly with CCPs) have incentives to clear centrally.” OTC DAT, *Regulatory reform of over-the-counter derivatives: an assessment of incentives to clear centrally*, 1 (Oct. 2014), available at (continued...)

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November 18, 2014
Page 9

would further urge such a study to gather data on margin, including data on the extent to which cleared derivatives exposures are collateralized by margin that is segregated and cannot be leveraged, as described in this letter.

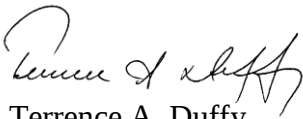
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Thank you for considering the issues raised in this letter. If you have any questions or need additional information, please contact Jacqueline Mesa, Executive Director, FIA Global, at 1 202-772-3040 or jmesa@fia.org.

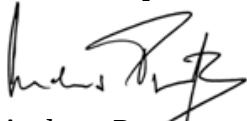
Yours faithfully,



Siddharta Roy
Chairman
CCP12



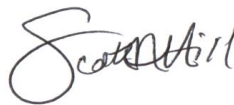
Terrence A. Duffy
Executive Chairman and President
CME Group



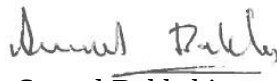
Andreas Preuss
Chief Executive Officer
Eurex Zürich AG and Eurex Frankfurt AG



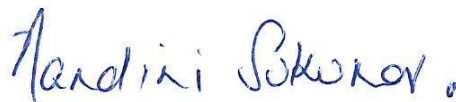
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Appendix B

FIA Global's April 20, 2015 Letter to the Basel Committee on Banking Supervision



April 20, 2015

Leverage Working Group
Policy Development Group
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

**Re: Follow-up to Questions Raised at Meeting of FIA with
the Leverage Working Group: Leverage Ratio
Treatment of Clearing Bank's Exposure When
Guaranteeing Trade of Client's Derivatives Transactions
with a Central Counterparty, Where the Client Posts
Segregated Margin**

Dear Sirs and Madams:

Members of FIA Global¹ very much appreciated the opportunity to meet with the Leverage Working Group in London on February 12, 2015 to discuss the deep concerns expressed in the FIA Global, CCP12, WFE, and major CCPs' November 18, 2014 letter (attached) to the Basel Committee on Banking Supervision ("BCBS"). As we discussed in the meeting, these concerns focus on the failure of the Basel Leverage Ratio² to recognize, in the context of a bank's guaranteed trade of a client's centrally cleared derivatives transaction with a central counterparty ("CCP"), the exposure-reducing effect of segregated margin posted by the client. There were a number of questions raised in the meeting that either were not addressed or not addressed in full by our November 18, 2014 letter. The purpose of this letter is to provide more detailed responses to these questions to help inform the BCBS's consideration of the treatment of segregated client margin. Accordingly, set forth below are each of the key questions raised, followed by FIA Global's response. We hope you find this helpful, and we would be pleased to discuss any additional questions or concerns you may have.

1. The bank derivatives exposures that FIA Global member banks are most concerned about: do they arise from transactions engaged in as principal or as agent?

¹ FIA Global, the alliance of FIA, FIA Europe and FIA Asia, is the primary global industry association for centrally cleared futures, options, and swaps. Its core members, many of which are banking organizations, are members of central counterparties ("CCPs"). FIA's membership also consists of the major global futures exchanges, clearinghouses, trading platforms, and others that, together, make central clearing possible.

² Basel Committee on Banking Supervision, *Basel III leverage ratio framework and disclosure requirements* (Jan. 12, 2014), available at <http://www.bis.org/press/p140112a.htm>.

As described above, the exposures at issue arise from a bank's guaranteed trade of a client's cleared derivatives transaction with a CCP where the client posts margin that is **segregated** to absorb losses generated by the transaction (recognizing, of course, that in some cases cleared

derivatives transactions do not involve margin that is segregated).³ Although the legal form may vary in different jurisdictions, clearing banks treat such a trade with segregated margin primarily as an **agency** transaction engaged in by the bank on behalf of the client to facilitate the client's transaction with the CCP, with the bank providing a backstop guarantee as principal for any **residual exposure**.⁴ Importantly, this residual exposure arises from a bank's role as facilitator of its client's trade, not from its own trade.

To be more specific, the residual exposure—the bank's real economic exposure—arises from the possibility that the amount of segregated margin posted by the client proves insufficient to satisfy losses generated by the client's transaction with the CCP (and the client otherwise fails to provide sufficient additional margin to pay for such amounts owed to the CCP). For pricing, risk management, and internal capital allocation purposes, the bank treats such a transaction as an agency transaction with a residual exposure that takes into account the value of the margin, rather than as a principal transaction that creates an exposure to the client that ignores the value of the margin. The bank does this because the client's margin is **segregated**, which means, as described in more detail below, that it is set aside to pay for any losses generated by the client's cleared transaction; cannot be re-hypothecated to leverage the bank; and is held in cash or extremely conservative, highly liquid investments so that, if the margin must be used to pay for the client's losses, it is readily available when needed to do so. In essence, because the bank can always rely on segregated margin being there to absorb the client's losses, the bank's real economic exposure is only to client losses that exceed the value of such margin.

³ See our November 18, 2014 letter to the BCBS, pp. 4-5 (highlighting that not all margin is segregated). FIA Global is seeking a reduction for **segregated** margin, *i.e.*, margin that cannot be re-hypothecated to leverage the bank.

⁴ As a legal matter, a clearing member bank in the United States facilitates trades for its clients by (1) acting as agent for its client's cleared derivatives trades with the CCP, and (2) guaranteeing the performance of the client to the CCP without entering into a separate transaction with the client. In Europe, by contrast, a clearing member bank facilitates trades for its clients using the "principal-to-principal," model, under which the bank engages in equal and offsetting trades with the client and the CCP. Standard market documentation in Europe provides that a clearing member bank's obligation to its client is relieved if, and to the extent that, the CCP defaults in its obligations to the bank, and paragraph 27 of the Basel Leverage Ratio recognizes that the bank has no exposure to the CCP under such a contractual arrangement. In such circumstances, the economic effect on the bank is similar under either the agent or principal-to-principal model: in both cases, the bank's economic exposure is a residual one, arising only if (1) the client defaults, and (2) the margin posted is insufficient to cover the client's exposure. For this reason, our responses in this letter describe transactions and guarantees that banks provide under the agency model, but are equally applicable to transactions under the principal-to-principal model.

2. **A clearing bank's guarantee of a client's transaction with a CCP creates an exposure in the denominator of the Basel Leverage Ratio that is affected by the client's segregated margin in two ways: an on-balance sheet effect and an off-balance sheet effect. Please describe this distinction and how accounting rules play a role in each.**

As set forth in more detail below, while FIA Global believes that the Basel Leverage Ratio should be revised to address both the on-balance sheet and off-balance sheet effects of segregated margin, it is most concerned with the off-balance sheet effect—that is, the standard's failure to recognize the exposure-reducing effect of segregated margin.

On-Balance Sheet Effect: Segregated Client Cash Margin Included in Denominator. As with leverage ratios used in many jurisdictions, the on-balance sheet part of the Basel Leverage Ratio is a simple, blunt measure that is expressly intended to follow accounting rules: in general, any on-balance sheet asset recognized under the applicable accounting regime—for example, Generally Accepted Accounting Principles (“GAAP”) in the U.S. or International Financial Reporting Standards (“IFRS”) in many other countries—is treated as an exposure for the purpose of the leverage ratio. Under some circumstances and in some jurisdictions, a client's cash margin in the context of the client's cleared derivatives transaction with a CCP is treated as an on-balance sheet asset of the bank under applicable accounting rules, including where the cash is passed along to a CCP or deposited in a segregated account at a third party bank. (However, a client's margin posted in the form of securities is often not treated as on-balance sheet accounting asset by the bank.) In these circumstances, where the accounting rules recognize the client cash margin as an on-balance sheet asset of the bank, the Basel Leverage Ratio includes the cash margin as an exposure in the leverage ratio denominator.

While we recognize the long history of leverage ratios tracking accounting rules to the maximum extent possible when calculating on-balance sheet exposures, FIA Global continues to believe that a client's segregated cash margin should not be treated as an asset of the bank—either for accounting purposes or under the Basel Leverage Ratio.

Off-Balance Sheet Effect: Segregated Client Margin Not Recognized as Offset or Reduction of Denominator. Of course, in addition to capturing on-balance sheet assets as recognized by the accounting rules, the Basel Leverage Ratio extends to certain off-balance sheet exposures, including exposures arising from a bank's guarantee of a client's cleared derivatives transaction with a CCP. In this context, however, the leverage ratio requirements have nothing to do with accounting principles, which by definition are designed to capture those exposures that qualify as on-balance sheet assets. Instead, in the off-balance sheet context first pioneered in the risk-based capital rules, the BCBS has devised its own set of standards to capture non-accounting-based, off-balance sheet risks that create real economic exposure for the bank. In the risk-based context, derivatives exposures, including a bank's guarantee of a client's cleared derivatives transaction with a CCP, are calculated as a residual amount net of margin posted by the client, because such an exposure represents the bank's *actual economic exposure*—and that economic exposure is

then risk-weighted according to the nature of the counterparty, similar to the way other credit exposures are risk-weighted in the risk-based capital rules.

In the Basel Leverage Ratio context, however, an off-balance sheet derivatives exposure, including a bank's guarantee of a client's cleared derivatives transaction with a CCP, is **not** calculated as a residual amount net of segregated margin, thereby, we believe, significantly overstating actual economic exposure. This difference in treatment of these exposures in the off-balance sheet context between the risk-based rules and the Basel Leverage Ratio is **not** driven by differences in accounting treatment—because in the off-balance sheet context, accounting principles are simply inapplicable. Instead, in the final Basel Leverage Ratio standard issued by the BCBS, the **only** policy rationale cited for not recognizing the exposure-reducing effect of margin on derivatives exposures was that such margin—while acknowledged as reducing exposures—“can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.” For reasons described below, FIA Global believes this rationale is especially inapplicable in the context of a bank's role in facilitating a client's cleared derivatives transaction with a CCP, where the client's margin is **segregated** and therefore cannot be leveraged by the bank.

3. Does segregation of the client's margin really mean that it will be there when needed to pay for the client's losses ahead of the bank, and in an amount equal to the full principal amount posted by the client?

Yes. For example, in the United States under the segregation rules established by the Commodity Futures Trading Commission (“CFTC”), strict legal requirements apply to ensure that (1) the margin is held separately from, and accounted separately from, the bank's other assets or assets under management; (2) the margin is “bankruptcy remote” from the bank's assets, so that, if the bank were to fail its creditors would have no rights to the margin ahead of the client or CCP; and (3) the margin instead must be held only in cash or other highly conservative, highly liquid investments such as U.S. Treasury securities (with appropriate haircuts to protect against severe market moves in the collateral value) so that it can quickly be monetized to pay for any client losses, if needed.⁵

⁵ 17 C.F.R. §§ 1.20-1.30 (futures); 17 C.F.R. §§ 22.2- 22.7 (cleared swaps). Under these rules, a bank must separately account for, and segregate as belonging to the client, all money, securities and property it receives from a client as margin. In addition, the bank may not use such segregated margin to support its own operations or reinvest the collateral except for investments in a narrow range of very low risk and highly liquid assets, such as U.S. government and municipal securities, managed “with the objectives of preserving principal and maintaining liquidity.” 17 C.F.R. § 1.25.

Similarly, in the United Kingdom, such segregation occurs with respect to clients that are provided money protection under the Client Asset Sourcebook (“CASS”).⁶

FIA Global believes that these existing segregation regimes plainly have the effect of making segregated margin available in full to pay for client losses ahead of the clearing bank. Nevertheless, if the BCBS remains concerned about the ability of a bank to engage in even extremely limited and highly conservative reinvestment of the client’s segregated margin, we would not object to a requirement that would prohibit such reinvestment as a condition for recognition of the exposure-reducing effect of such margin; in essence, such a requirement could mandate that segregated cash margin received could only be held in cash accounts, such as bank deposits, and segregated securities margin received could not be transformed into other types of securities.

4. Doesn’t the bank keep the interest earned on the segregated margin once it is posted? Doesn’t that mean that the margin is in some sense really the bank’s asset, not the client’s, and is being used to leverage the bank, which is what the leverage ratio is trying to capture?

In the final Basel Leverage Ratio standard issued by the BCBS, the only policy rationale for not recognizing the exposure-reducing effect of margin on derivatives exposures was that such margin—while acknowledged as reducing exposures—“can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.”⁷ That policy rationale may be a valid concern with respect to margin posted in certain uncleared OTC derivatives transactions, where currently it can and often is re-used or re-hypothecated by the bank to help fund its general operations. But the rationale simply does not apply to margin posted by clients in connection with their cleared trades with CCPs that are subject to the strict segregation rules of the CFTC and comparable regulatory regimes in other jurisdictions; such segregated margin may not be re-used or re-hypothecated to leverage the bank.⁸

That said, in some jurisdictions a bank is allowed to keep an agreed portion of the income earned on segregated margin as one type of payment for the services the bank provides to facilitate the client’s cleared transaction with the CCP. As discussed above, segregated margin may only be held in cash or highly conservative, liquid investments; it cannot be used to leverage the bank in the manner contemplated by the Basel Leverage Ratio.⁹ The amounts banks earn on such

⁶ CASS 7.3.1R and CASS 7.4.1R.

⁷ Basel Leverage Ratio, at ¶ 22.

⁸ See, e.g., 17 C.F.R. § 1.22(a) (prohibiting a bank from using the funds of a futures customer to purchase, margin, or settle the trades, contracts, or commodity options of, or to secure or extend the credit of, any other person); 17 C.F.R. § 22.2(d) (same rule for swaps customers).

⁹ *Id.*

conservative investments is relatively modest, especially in the current interest rate environment; in higher rate environments, banks often pass through part of the income earned to the client after keeping an agreed amount necessary to cover their fee for the services rendered.

- 5. Leverage ratios have generally not recognized the exposure-reducing effect of collateral on on-balance sheet credit exposures like loans; for example, the leverage ratio exposure of a residential mortgage loan is not offset by the value of the house securing that loan. Why should there be a deviation from this principle for the off-balance sheet exposure created by a bank's guarantee of a client's derivatives transaction with a CCP?**

There are four reasons why margin segregated for centrally cleared derivatives transactions should be treated differently.

- **First, unlike accounting-recognized on-balance sheet assets (like loans) that have always constituted the primary exposures used for leverage ratio measures, the Basel Leverage Ratio extends for the first time to off-balance sheet exposures like derivatives that are not driven by accounting rules—and in this off-balance sheet context, it is appropriate to focus on actual economic exposure, not traditional accounting measures of exposure.**

As described above, leverage ratios have traditionally been simple, blunt on-balance sheet measures that follow accounting rules: in general, any exposure that is treated as an on-balance sheet asset under IFRS, GAAP, or comparable accounting regimes is treated as an exposure for the purpose of the leverage ratio. Because collateral is typically not recognized by such accounting regimes as reducing the value of an on-balance sheet loan, leverage ratios typically do not recognize the exposure-reducing effect of collateral on that on-balance sheet asset. Following this basic principle, efforts to modify the leverage ratio treatment of on-balance sheet assets to deviate from accounting principles have generally been resisted as a “slippery slope” that would undermine the simplicity of the leverage ratio or begin to transform it into a risk-based concept, which is not what it is intended to be.

But, as also previously described, in the off-balance-sheet context, the derivatives exposures at issue are **not** on-balance sheet assets driven by accounting rules or principles. Instead, they are solely regulatory measures established by the BCBS to capture off-balance sheet exposures that by definition are not captured by on-balance sheet accounting rules. In this context, the BCBS has far more discretion to deviate from accounting principles that do not adequately capture true economic exposure.

In the context of a bank guaranteeing a cleared derivatives exposure by a client to a CCP, segregated margin is not merely a “risk mitigant” that should affect the relative riskiness of the derivatives exposure, which is plainly a risk-based capital concept. Instead, because the margin is segregated, of especially high quality (often cash), and always readily available to be used in the event of the client's default, it literally reduces the **exposure** itself by the amount of the margin,

not just the **risk** of the exposure. As previously described, that is how clearing banks have always viewed the exposure for risk management, pricing, and internal capital allocation purposes, that is, as a residual exposure net of segregated client margin, **not** as the nominal amount of the exposure that is then risk-weighted to reflect the nature of the counterparty, as would be the case in the risk-based context.

Again, the point here is that the actual economic exposure is the residual exposure, and in the **off-balance sheet context**, there is far more flexibility for the Basel Leverage Ratio standard to recognize actual economic exposure even if doing so deviates from a concept that is used by accounting regimes to measure on-balance sheet exposures.

- **Second, client-cleared derivatives trades are functionally agent transactions, not principal transactions.**

Unlike loans and other transactions that a bank enters into as principal, client cleared derivatives are initiated by the bank's client. The bank's role is only as a facilitator of the client's trade—again, as described above, the bank is functionally acting as agent, not principal.

- **Third, there is analogous precedent in the Basel Leverage Ratio itself that recognizes offsets for collateral in the off-balance sheet context and treats only the residual exposure as the relevant exposure for leverage ratio purposes.**

Where a bank acts as agent in a securities financing transaction (SFT) and guarantees a client's exposure net of collateral posted by the client, the Basel Leverage Ratio provides that **only the residual exposure** will be captured for leverage ratio purposes. In essence, because the bank's economic exposure is limited to the residual exposure, the leverage ratio exposure is similarly limited. While the language of the provision makes clear that the bank's legal exposure in this context needs to be limited to the residual exposure, the economics of the exposure is the driving rationale.

A clearing bank's economic exposure is identical in the very analogous context of acting as agent to facilitate a client's cleared derivatives transaction with a CCP: by virtue of its backstop guarantee, the bank is economically "on the hook" for the residual exposure net of the segregated margin posted by the client. While the legal form of this guarantee may be somewhat different due to the way the business has developed with CCPs—with the guarantee covering the full exposure but with highly liquid collateral always readily available to offset the collateral—the economics are the same.

Moreover, a bank's role is functionally the same in the case of SFTs and cleared derivatives: in both types of transactions, the bank is merely facilitating the trades of its client, which is the ultimate end-user of the product, as a service to the client; it is not making a trade for its own account.

As a result, because of this economic and functional equivalence, a bank's guarantee of a client's derivatives transaction with a CCP should be treated as a residual guarantee for leverage ratio purposes, just as a comparable guarantee is treated as a residual guarantee in the SFT context under the Basel Leverage Ratio standard.

- **Fourth, the Pittsburgh G20 commitments of 2009 established a clear policy that mandatory clearing of certain derivatives is essential to improving risk management and promoting financial stability, and there is no such commitment for loans and other transactions that a bank enters into as principal.**

The Basel Leverage Ratio will be at odds with the G20 commitments unless it is amended to recognize the exposure-reducing effect of segregated margin. The current treatment of segregated margin will disincentivize clearing members from working with clients that create a higher balance sheet and leverage ratio impact; clients that typically enter into long-dated, very directional derivatives transactions (such as pension funds and insurance companies, for example), fall into this category. The Basel Leverage Ratio should not be structured to deter banks from providing this important client service.

6. As a practical matter, would recognizing the exposure-reducing effect of segregated client margin mean that a clearing member bank would not be required to hold any capital in connection with the bank's guarantee of a client's derivatives transaction with a CCP?

No. Although a bank's economic exposure is appropriately reduced by a client's posting of segregated margin in these circumstances, and the bank's direct exposure in the leverage ratio denominator should be correspondingly reduced, the bank still must hold capital against the exposure, for the following reasons.

First, in the risk-based context, the new Standardized Approach to Counterparty Credit Risk (SA-CCR) includes a floor in its PFE multiplier.¹⁰ This means that a minimum level of regulatory capital will always be required to be held against a bank's guarantee of a client's cleared derivatives transaction with a CCP. And if the BCBS were to adopt SA-CCR in the context of the Basel Leverage Ratio, the SA-CCR floor feature would ensure that a minimum amount of leverage exposure is added to the denominator of the bank's Basel Leverage Ratio to recognize exposure created by a client's derivative transaction with a CCP.

¹⁰ See Basel Committee on Banking Supervision, *The standardised approach for measuring counterparty credit risk exposures*, at p. 8 ¶ 148 (Mar. 2014; rev. Apr. 2014), available at <http://www.bis.org/publ/bcb279.htm>.

Second, a clearing member bank is required to make contributions to a CCP's default fund, which is there to absorb losses from the CCP's counterparties as necessary, including those counterparties whose exposures to the CCP are guaranteed by the bank. Such default fund contributions are captured as on-balance sheet exposures in the denominator of the Basel Leverage Ratio.

Third, in the United States, CFTC rules require a clearing member bank to provide its own funds (known as "residual interest") to accounts holding segregated margin in an amount equal to or greater than its clients' aggregate undermargined accounts.¹¹ In effect, these rules require a bank to provide an amount of its own funds that provides an extra buffer against residual losses it might incur in clearing client trades, *i.e.*, the exposures arising from the amount of shortfall in margin that banks may be required to cover to the CCP. Under the Basel Leverage Ratio, this residual interest is treated as an on-balance sheet exposure against which the bank must hold capital.

Reflecting these points, and responding to a request from U.S. regulators, FIA has collected information from its members operating in the United States that demonstrates quantitatively that, even if the exposure-reducing effect of segregated margin were recognized under the Basel Leverage Ratio, banks would still be required by that standard to hold a significant amount of capital that is directly related to client-cleared derivatives transactions. This information has been shared with these institutions' U.S. regulators.

* * *

Please let us know if you have any questions regarding our responses provided above.

Sincerely,



Walter L. Lukken
President and Chief Executive Officer
FIA Global

¹¹ 17 C.F.R. § 1.22(c)(3)(i).