



London Stock Exchange Group response to BCBS consultation paper on potential changes to the Leverage Ratio Treatment of client cleared derivatives

Introduction

The London Stock Exchange Group ("LSEG") is a financial market infrastructure provider, headquartered in London, with significant operations in Europe, North America and Asia. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all of its businesses.

LSEG operates multiple clearing houses. It has majority ownership of the multi-asset global CCP operator, LCH Group ("LCH"). LCH has legal subsidiaries in the UK (LCH Ltd), France (LCH S.A.), and the US (LCH LLC). It is a leading multi-asset class and international clearing house, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes, including: securities, exchange-traded derivatives, commodities, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repos.

In addition, LSEG operates Cassa di Compensazione e Garanzia S.p.A. ("CC&G"), the Italian clearing house, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives.

Executive Summary

LSEG welcomes BCBS's initiative to consult on potential changes to the Leverage Ratio treatment of client cleared derivatives. As we have previously commented, we firmly support the G20 objective of promoting central clearing and encourage the review and amendment of prudential frameworks to promote central clearing, where such amendments would not compromise financial stability.¹ We believe that segregated client Initial Margin ("IM") deposited with Clearing Members ("CMs") should be recognised within the Leverage Ratio framework to prevent unnecessary constraints being imposed to CMs.

General remarks

- LSEG supports the Leverage Ratio as the prudential metric that prevents excessive leverage in the banking system and acts as a backstop to the risk-sensitive capital framework.
- The resilience of banks, in their capacity as CMs, is paramount for safeguarding the central risk management role that CCPs have in the financial system. This is even more the case for client clearing, where CMs guarantee the performance of their clients to the CCP.
- The recognition of the risk-reducing effects of segregated client IM, in respect of client clearing, within the Leverage Ratio framework would have positive effects in the market. Capital requirements that disproportionately constrain client clearing capacity and/or prohibit new market participants from accessing central clearing services inadvertently work against the market dynamics that the G20 were looking to reinforce and increase risk of CMs refusing to accept porting of Clients during a default, particularly if doing so brings significant capital implications.
- LSEG supports Option 3, aligning the treatment of client cleared derivatives with the measurement as determined per the SA-CCR, as used for risk-based capital requirements, to facilitate quick adoption in

¹ LCH response to BCBS Revisions to the Basel III Leverage Ratio Framework, 6 July 2016, available at <https://www.bis.org/bcbs/publ/comments/d365/lchclearnetgrou.pdf>;

Joint Industry letter to FSB, GHOS, and BCBS, Treatment of Cleared Client Initial Margin in the Leverage Ratio, 3 Nov 2016, available at <https://fia.org/articles/pan-industry-coalition-urges-international-banking-regulators-revise-leverage-ratio>;

LCH response to BCBS 251 - Revisions to the Basel III Leverage Ratio Framework and Disclosure Requirements, 20 Sep 2013, available at <https://www.bis.org/publ/bcbs251/lchclearnet.pdf>.



industry by alleviating implementation difficulties and ensuring there is harmonisation with jurisdictions that have moved forward with respective legislative proposals.

LSEG highlights that the Leverage Ratio can become the binding constraint in low-risk business activities and believes adjustments should be made where such activities enhance financial stability and meet the G20 objectives of promoting central clearing. Hence, LSEG supports the recognition of the risk-reducing effects of segregated IM in calculating the exposure measure in Leverage Ratio.

You will find below detailed responses to the question raised in the consultation paper.

1. Is there concrete and robust empirical evidence that would warrant a revision to the Leverage Ratio treatment of client cleared derivatives?

LSEG believes that the segregated IM that a CM collects from its clients is risk reducing and should be reflected in the exposure calculation of the Leverage Ratio. We are fully supportive of using the Leverage Ratio as a tool to prevent the build-up of excessive leverage, however we must stress the importance of enabling CMs to be capitalised in line with the risks they bear, without being unnecessarily penalised.

When CMs do not collect any collateral from a client, capital should be set aside against that exposure; however, as the amount of collateral collected increases, and where the collateral collected is not available to the CM (passed on to the CCP), it doesn't seem reasonable to require the CM to set aside the same amount of capital. The recognition of IM would appropriately promote increased postings of collateral, such that CMs and clients seek a balance between capital and collateral costs.

Analysis

LSEG welcomes BCBS's suggestions on the treatment of client cleared derivatives to allow IM (cash and non-cash) to offset the potential future exposure of derivatives centrally cleared on the client's behalf.

In 2016, looking at the client clearing portfolios of the top 6 CMs (representing circa 70% of the service's client clearing notional volume), LCH concluded that the recognition of clients' IM would lead to a 50% reduction (circa GBP 160mn) in capital requirements calculated as per the standardised approach to counterparty credit risk ("SA-CCR"), Option 3.²

It is worth noting that the transition to SA-CCR could lead to even higher capital requirements than the Current Exposure Method (CEM) for directional portfolios. Thus, recognising IM would be more important under this framework.

In October 2018, SwapClear (i) updated the previous analysis on Option 3 and (ii) explored Option 2 described in the consultation paper. Looking at the client clearing portfolios of the top 3 CMs (representing circa 45% of the service's client clearing notional volume), the recognition of client IM generated the following capital saving results:

Capital savings	Option 2	Option 3
Total	~£ 95m / ~50%	~£ 105m / ~55%
of which,		
- Real money clients	~£ 40m / ~65%	~£ 45m / ~75%
- Banks	~£ 25m / ~60%	~£ 25m / ~55%
- Hedge funds	~£ 30m / ~35%	~£ 35m / ~40%

One important conclusion is that clients from the real economy could be disadvantaged the most if client IM was not recognized in the Leverage Ratio exposure calculation, given that their portfolios are generally more directional. This could compound the effect from the expected capital requirements increase due to transitioning from CEM to SA-CCR. Some types of clients (for e.g. pension funds under the EU framework) have not sought CM capacity as they currently benefit from specific clearing exemptions. This has allowed more CM capacity to be available to other clients. When these exemptions expire, the

² LCH Response to BCBS, 2016, p. 2.



industry may experience an unnecessary shortage to CM capacity and/or scarce remaining capacity might be charged at a premium to its risk-adjusted cost of provision.

With regards to the preferred option, we note that the differences in capital savings between Option 2 and 3 are immaterial. In light of this, LSEG supports Option 3 (i.e. the same specification as with the risk-sensitive methodology) to facilitate quick industry adoption by alleviating implementation difficulties and ensuring there is harmonisation with jurisdictions that have already moved ahead with respective legislative proposals (e.g. CRR II). Moreover, LSEG believes that Option 2 is less effective as it does not allow variation margin to offset the portfolio's mark-to-market within the Potential Future Exposure (PFE) multiplier formula because the PFE would be incorrectly reduced in of out-of-the money portfolios.

2. To what extent would the two potential revisions discussed in this consultative document adequately meet the G20 Leaders' policy objectives of strengthening the resilience of the banking system by preventing excessive leverage and promoting central clearing of standardised derivative contracts?

Clearing Capacity

Recognition of IM posted by clients in the Leverage Ratio will appropriately calibrate costs to support the provision of client clearing services and will incentivise more market participants to use centrally clearing facilities, further reducing counterparty risk exposures in the system.

This was clearly demonstrated in the consultation report on "Incentives to centrally clear over-the-counter (OTC) derivatives A post-implementation evaluation of the effects of the G20 financial regulatory reforms – final report" by BCBS, CPMI, FSB and IOSCO ("FSB DAT report")³.

The report showed that G-SIBs that clear the majority of OTC derivatives client business were not constrained by the Leverage Ratio on a house level but at a client clearing level. 64.7% of all Client Clearing Service providers (CCSP) responded that the leverage ratio had a significant negative impact and 23.5% of respondents said there is some negative impact. This means that a large majority of 88.2% of responding firms see negative impact of the leverage ratio.

CMs will be forced to fully or partially pass these increased capital costs down to their clients, making central clearing more expensive as the number of affected clients and products subject to clearing mandates continues to increase globally. Thus, recognizing IM in the exposure calculation would materially preserve and promote increased clearing capacity amongst clearing members including with the real economy without creating material additional capacity elsewhere.

Although the reduction in the clearing capital requirements seems to be significant in percentage terms, it is not material in absolute terms to the bank as a whole (top of the house). Therefore, although client clearing will be supported, we would expect that the resilience of the banking system will not be materially altered.

Portability

The lack of recognition of IM can have significant impacts to central clearing of standardised derivative contracts, which can lead to increased systemic risk. Without capital relief, there is an increased risk of CMs refusing to accept the porting of clients during a default, particularly if doing so brings significant capital implications. Therefore, there is an associated increased risk of tear-up of client positions in the event of CM's default. This clearly goes against the incentives for clearing for buy-side and real money clients and introduces increased risk to market stability during what are already likely to be stressed market conditions.

Providing the right incentives to increase clearing capacity through the revision of capital treatment for risks associated with carrying client positions of defaulting CMs, particularly around calculation of the Leverage Ratio, would prevent systemic risks by reducing barriers to porting.

³ FSB DAT Report, <http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf>



Concentration of Client Clearing Service Providers

The FSB DAT report showed that 80% of client clearing margin for cleared OTC derivatives in the US, UK and Japan is concentrated on five firms.⁴ If one of those CMs defaults, the remaining CMs would have to increase capacity to accommodate porting of clients' positions from the defaulting CM. The Leverage Ratio requirement doesn't provide the right incentives to those CMs to bid for a portion of the defaulting members portfolio as explained in the section above.

Ultimately, the recognition of initial margin in the Leverage Ratio calculation may prevent CMs from incurring excessive capital costs associated with their client clearing business and prevent the increase of systemic risk by raising barriers to porting. Furthermore, collateral segregation structures within CCPs are currently available to ensure that margin is posted for the limited purpose of guaranteeing client trades and therefore segregated away from the bank's own money, if not completely outside of the bank's control.

3. What are the potential forward-looking behavioural dynamics of the client clearing industry that could occur as a result of possible changes to the leverage ratio treatment of client cleared derivatives?

The cleared derivatives industry is likely to experience a continued increase in demand for client clearing services in the future. This trend will positively contribute to limiting systemic risk and we believe that appropriate measures must be taken by the industry to pave the way for the onboarding of new segments of clients to centrally clearing services. In Europe, recent studies by Pensions Europe and ISDA⁵ estimate that when European pension funds start clearing large volumes of trades, an increase in IM of approximately EUR58bn will be required over a number of years to provide clearing services to pension funds. If we were to compare this estimated figure with the EUR77bn of client IM held by the three major CCPs for interest rate swaps, one could easily come to the conclusion that such an increase would have substantial capital costs for CMs.

Creating incentives to increase clearing capacity and to limit costs to end users should be key considerations in evaluating this policy decision. CMs must be in a position to safely onboard new clients without being unnecessarily penalised for doing so by bearing excessive capital costs – capital costs imposed to CMs which are likely to be passed on to the end users, therefore disincentivising the use centrally cleared services.

Recognition of IM would reduce costs associated with the provision of client clearing services, therefore promoting increased clearing capacity amongst clearing members and limiting systemic risk to the derivatives market.

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We hope that you will find LSEG's input provided in this consultation paper useful and we remain at your disposal for any additional clarifications.

⁴ FSB DAT Report, p. 3.

⁵ <http://www.fsb.org/wp-content/uploads/ISDA-Pensions-Europe-joint-response.pdf>.