

Mr. William Coen  
Secretary General  
Basel Committee on Banking Supervision  
Bank for International Settlements  
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**The Investment Association**

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**Date: 5 July 2016**

Dear Sir

**Basel Committee on Banking Supervision: Revisions to the Basel III Leverage Ratio Framework (LR) – Consultative Document (Apr. 2016)**

The Investment Association supports the policy goals of the LR, but we are specifically concerned with the impact on derivatives and securities financing transactions (SFT).

The Investment Association represents the UK-based investment management industry and is the second-largest national “buy-side” trade association in the world (and the largest in the EU) by total assets under management of our members: over £5.5 trillion AuM; around one third of the EU’s managed assets.

While our members and their clients are not subject to the LR rules directly (unless, of course, the investor client is a bank), they often indirectly bear the burden of these rules as they trade with banks and banks look to pass on any cost or impact of the LR to their clients. The one-directional and long-dated nature of many investors’ portfolios (e.g. European pension funds) means that changes in regulation often have a disproportionate impact and have the potential to unduly penalise those investors. These investors’ derivatives portfolios reflect the long-dated nature of their liabilities, which, in the case of pension funds, can stretch to 60 years based on the actuarial estimation of the life expectancy of current or future retirees.

Investor derivative portfolios that are one-directional should not be overly penalised by regulation intended for risky institutions. This is because derivatives portfolios offset risks that are naturally inherent for such investors and, therefore, help them to reach a minimal risk position.

**Derivatives**

Our principal concern is with the treatment of derivatives. For this reason we co-signed the joint trade association response to this consultation lead by AIMA (“joint TA response”). In addition, we wanted to raise several issues of particular concern to asset managers and their clients.

Derivatives allow investors to tailor investment objectives and to hedge risks. However, the LR materially penalises derivatives in the following ways:

- SA-CCR methodology disproportionately penalises one-directional investment portfolios
- High quality government bond securities, with appropriate haircut, should be permitted to offset replacement cost in OTC derivatives exposure calculation
- Initial margin should be permitted to offset both cleared and non-cleared trades
- Treatment of inflation swaps within SA-CCR should be explicit and the asset class should be categorised within the same asset class as interest rates



It is reasonable to expect that the increase in capital requirements for banks resulting from the LR will increase costs to banks. It may also negatively impact market liquidity that is already subdued due to the impact of other regulatory initiatives (e.g. NSFR). In particular, our members expect to see costs associated with trading derivatives increase significantly as a result of higher capital requirements for banks. Indeed, our members already report signs of these adverse impacts ahead of the commencement of the LR.

### **SA-CCR methodology disproportionately penalises one-directional investment portfolios**

The impact of SA-CCR needs to be fully calibrated to portfolios of all derivative users including pension funds and other end-users, not just banks. While the SA-CCR methodology brings netting benefits to banks, the consequences for our members are difficult to assess. Some members expect this netting benefit to enable banks to release balance sheet capacity. However, the benefit of extra balance sheet capacity will depend on the way banks allocate their balance sheet.

The SA-CCR can disproportionately penalise European pension funds' one-directional portfolios, with one member reporting that the SA-CCR increases exposure up to four times that of the CEM methodology on a sample European pension fund portfolio. However, any change to SA-CCR calibration should retain the netting benefits and we do not advocate simply returning to CEM.

We are concerned that SA-CCR, combined with the lack of recognition of securities VM, is likely to make the non-cleared OTC derivatives market unusable for certain categories of long-term investors, notably, European pension funds. Entities such as European pension funds that benefit from a clearing exemption should not be penalised for accessing the OTC derivatives market through non-cleared trades. Unless this issue is addressed, we expect banks to increase the pricing of trading derivatives with European pension funds in the future significantly, or refrain from providing liquidity to them.

### **High quality government bond securities, with appropriate haircut, should be permitted to offset replacement cost in OTC derivatives exposure calculation**

The lack of recognition of any non-cash VM, even high-quality government bond collateral, to reduce the replacement cost of OTC derivatives is leading to banks putting pressure on clients to post cash only VM when trading non-cleared derivatives with them. This is likely to force European pension funds and other end users to either post VM in cash, or be shut out of the derivatives market. In the EU this would undermine the policy objective reflected in EMIR and CRR that European pension funds should not be forced to post margin in cash and that the non-cleared markets must remain workable for them.

### **Initial margin should be permitted to offset both cleared and non-cleared trades**

Segregated IM posted should be allowed to offset OTC derivatives exposure for both cleared and non-cleared trades. Currently the consultation paper only raises the question as

to whether IM should offset OTC derivatives exposures of cleared trades but it is also necessary that it is allowed to offset OTC derivatives for non-cleared trades as well. This is of particular importance given that the move to SA-CCR from CEM disproportionately penalises one-directional portfolios that are likely to be held by end-users.



Segregated IM cannot be re-used and therefore it cannot be leveraged to take more risk. It is provided by counterparties so that it is available to offset risk in the event of a default, and as such it should be recognised by the LR. We see no reason for not allowing segregated IM to offset OTC derivatives exposure of non-cleared trades.

Given the regulatory requirement to post IM and strict rules around segregation of IM in many jurisdictions (deriving from the BCBS and the International Organization of Securities Commissions (IOSCO) standards on margining non-cleared derivatives), we are surprised by the lack of recognition by BCBS of such IM in offsetting risk for the purpose of the LR.

The segregated IM provided by clients is precisely there to provide protection in the event of a client default and should be recognised as such. The lack of recognition for this is making client clearing expensive and making clearing unworkable even though regulators have mandated clearing.

The lack of pragmatic capital rules around central clearing is leading to banks exiting the clearing broker business. Clients are left with a decreasing number of banks willing to provide good clearing broker services. The combined effect of this and mandated clearing is likely to increase clients' concentration risk to banks significantly. The shrinking market for clearing members puts into question whether porting can really work in either stressed market conditions or in the event of a clearing member default. Ability to port to an alternate clearing member is critical to client clearing in a stressed environment.

For client clearing to be robust and resilient in an environment where clearing is mandated internationally, end users need a greater supply of, and competition among, banks willing to provide clearing broker services. Allowing client IM to offset OTC derivatives exposures to cleared trades goes somewhat towards helping to relieve the capital burden on banks for clearing broker services, which should make the client clearing business more viable for banks and more cost effective for clients.

### **Treatment of inflation swaps within SA-CCR should be explicit and the asset class should be categorised within the same asset class as interest rates**

SA-CCR sets out that netting is possible within an asset class but not across asset classes. Asset classes are defined to be interest rate, foreign exchange, credit, equity and commodities. The rules are not explicit in terms of where inflation sits as an asset class. We would expect inflation risk to be treated within the same class as interest rate risk given their strong economic link. We note that the non-cleared margin standards agreed by BCBS and IOSCO treats inflation as being within the same asset class as interest rates.

We request that regulators make this clear and explicitly state that inflation should be within the same asset class as interest rates for the SA-CCR calculation.

### **Bank capital rules should not dis-incentivise direct access client clearing models**

Policymakers should not impede the evolution of direct access client clearing models through bank capital rules that dis-incentivise the development of this product and market. This is likely to require that direct access clearing models have lower capital charges applied for clearing brokers, including through the leverage ratio, such that client clearing becomes a more attractive business for banks again. This we think will increase competition and bring more clearing brokers back to the market. This is important to reduce concerns of concentration risks to clearing brokers and to ensure that porting can work when needed.

## **Securities Financing Transactions**



The impact of the LR, if simply adopted exactly as outlined by the BCBS, would add stress to, and weaken the effectiveness of, the repo market and, given their interwoven relationship, the collateral market.

We believe that there are a number of ways in which the LR could be adapted in order to ameliorate its effects on repo and collateral markets. In this regard, we endorse the response to this consultation by the International Capital Market Association's ("ICMA's") European Repo and Collateral Council ("ERCC") concerning the impact of the LR on repo.

Yours Faithfully

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**Senior Adviser**