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SUBMITTED via E-MAIL: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

July 5, 2016

Re: BCBS Revised Basel III Leverage Ratio Framework-Consultative Document (April 25, 2016)

The American Council of Life Insurers (ACLI) is a national trade association with 280 member companies that represent 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Our members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance that 75 million American families rely on for financial and retirement security.

We greatly appreciate the opportunity to share our views on the Consultative Document (April 25, 2016)<sup>1</sup> issued by the Basel Committee on Banking Supervision outlining the Revised Basel III Leverage Ratio Framework (the “Revised Leverage Ratio Framework”), an important component of the overall regulatory framework for the Banking sector. Life insurers have actively participated in the global dialogue concerning the regulation of derivatives and stable financial markets, including the BCBS initiative on margin for uncleared swaps<sup>2</sup>.

Life insurers are among the financial end users affected by the leverage ratios under consideration in the Consultative Document. ACLI filed a submission dated September 20, 2013, with the Basel Committee on Banking Supervision (BCBS) on its initial consultative document<sup>3</sup> that proposed a revised Basel III leverage ratio framework through a supplementary measure of the Risk Based Capital (“RBC”) requirements for Banks.<sup>4</sup> We have attached a copy of our 2013 comments<sup>5</sup> for background and convenience as an appendix to this submission.

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<sup>1</sup> <https://www.bis.org/bcbs/publ/d365.pdf>

<sup>2</sup> See ACLI [submission](#) dated September 28, 2012 on the BCBS-IOSCO Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (<http://www.bis.org/publ/bcbs226/acoli.pdf>), and ACLI [submission](#) dated September 28, 2012 on the BCBS-IOSCO First Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (<http://www.bis.org/publ/bcbs226/acoli.pdf>).

<sup>3</sup> <http://www.bis.org/publ/bcbs251.pdf>

<sup>4</sup> For those readers outside BCBS, a brief overview about the proposal may be informative. Currently, the Basel III leverage ratio framework uses the Current Exposure Method (CEM) to measure the replacement cost (RC) and the potential future exposure (PFE) for derivative transactions, with certain leverage ratio-specific modifications to limit the recognition of collateral. According to the Consultative Document, this approach captures the exposure arising from the underlying of the derivative contract and counterparty credit risk (CCR) exposure. However, when the Basel III leverage ratio framework was published in January 2014, BCBS noted that it would consider replacing the Basel III leverage ratio framework’s use of the CEM with an alternative approach adopted under the risk-based framework.

In March 2014, BCBS published a standardized approach for measuring counterparty credit risk exposures (SA-CCR) to specify the measurement of derivative exposures for risk-based capital purposes in replacement of both the CEM and the standardized Method. The Basel III leverage ratio framework lays out several general principles, including the concept that “banks must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the [leverage ratio] exposure measure” and to ensure overall consistency with the Basel framework. According

The 2016 Consultative Document largely reflects the substance and concepts of the initial Revised Leverage Ratio Framework. Our 2013 submission recognized that the purposes of the Basel III reform included restricting the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. ACLI emphasized, however, that aspects of the proposal would significantly impair market functionality, liquidity and transaction costs in markets that the insurance industry relies upon. We explained that the proposed change would unnecessarily reduce market liquidity and increase costs in the fixed income and derivative markets, in its attempt to mitigate broader systemic risks. We continue to have the same concerns about the 2016 Consultative Document.

ACLI recognizes the substantial effort and consideration that the Basel Committee on Banking Supervision has dedicated to introducing a transparent, supplementary measure to the Risk Based Capital (“RBC”) requirements for Banks. Further, the ACLI fully recognizes the important implications for ensuring a global regulatory framework for more resilient banks and banking systems. However, the 2016 version of the Revised Leverage Ratio Framework will continue to inflict several negative market consequences in its attempt to mitigate broader systemic risks.

In particular, we remain concerned about the potential impact to the fixed income and derivative markets. Large portions of the fixed income and derivatives markets will be impacted by the proposed changes to the netting of Securities Financing Transactions (SFTs). Additionally, the derivatives markets will also suffer an unnecessarily negative impact through the inclusion of collateral in the Exposure Measure. Finally, the credit derivatives markets are likely to be adversely affected from more restrictive off-sets for purchased credit derivatives.

As we indicated in our 2013 submission, ACLI understands that the Basel III reform introducing a simple, transparent, non-risk based leverage ratio is intended as a credible supplementary measure to RBC requirements. We recognize that the leverage ratio is intended to restrict the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. Nonetheless, several aspects of the proposal will significantly impair market functionality, liquidity and transaction costs in markets on which life insurers rely. Again, we recommend that the Basel Committee deliberately consider the following modifications:

- Continued allowance of netting for Securities Financing Transactions when the underlying securities consist of Government Securities;
- Exclusion of collateral posted or received in connection with derivatives transactions; and
- Recognition of maturity mismatches on a proportional basis in respect of credit derivatives.

These suggestions dovetail with the overall purpose of the Consultative Document and avoid counterproductive and perhaps unintended consequences that unnecessarily impair market functionality, liquidity and transaction costs in markets that the insurance industry relies upon.

We have reviewed a letter prepared by Asset Management Group (“AMG”) of the Securities Industry and Financial Markets Association (“SIFMA”) concerning the 2016 Consultative Document that provided evidence and data related to the impact of the Basel Leverage Ratio on end users.

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to the Consultative Document, therefore, BCBS intended to implement a modified version of the SA-CCR to ensure consistency with these fundamental principles of the Basel III leverage ratio framework, especially with respect to not recognizing collateral to reduce the leverage ratio exposure measure.

<sup>5</sup> See ACLI 2013 [comments](http://www.bis.org/publ/bcbs251/acoli.pdf) on the First BCBS Consultative Document on the Revised Basel III Leverage Ratio Framework (<http://www.bis.org/publ/bcbs251/acoli.pdf>).

SIFMA AMG conducted a survey revealing that the Basel Leverage Ratio's failure to recognize the exposure-reducing effect of segregated initial margin is already having an adverse effect on end users, with some reporting the termination of a clearing relationship by their clearing broker due to the standards in the proposed Consultative Document. Our members have also experienced many of the same effects reported in the SIFMA AMG letter's data, such as higher clearing fees and requests to re-route execution business to avoid larger clearing fees. As mentioned in the SIFMA AMG letter, these effects have a particularly sharp impact on life insurers, as we generally employ lower-frequency trading and more directional trading strategies than other end users. In short, central clearing is becoming more costly and more difficult to access. Because life insurers' primary use of derivatives is for hedging the risks associated with their investments portfolios and insurance and annuity product liabilities, the general impact of the proposed approach would restrict the insurance industry's ability to manage and hedge financial risk. These collateral consequences seem contrary to overall stability in the derivatives marketplace.

Thank you for your attention to our views. If any questions develop, please let me know.

Sincerely,

/S/

Carl B. Wilkerson

(Appendix follows on next page)



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SUBMITTED via E-MAIL: baselcommittee@bis.org

September 20, 2013

Re: BCBS Revised Basel III Leverage Ratio Framework

The American Council of Life Insurers (“ACLI”) is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. In addition to providing life insurance, annuity and employee benefit programs on a global basis, many of our members are large participants in the fixed income markets, including U.S. Treasury securities, as well as repurchase and reverse repurchase agreements. Our members manage asset and liability risks by hedging with derivatives instruments.

We respectfully submit our comments on the Consultative Document issued by the Basel Committee on Banking Supervision outlining the Revised Basel III Leverage Ratio Framework<sup>1</sup> (the “Revised Leverage Ratio Framework”), an important component of the overall regulatory framework for the Banking sector. Life insurers are among the financial end users affected by the leverage ratios under consideration in the Consultative Document. Life insurers have actively participated in the global dialogue concerning the regulation of derivatives. We greatly appreciate your attention to our views

## **I. Summary of Position**

ACLI recognizes the substantial effort and consideration that the Basel Committee on Banking Supervision has dedicated to introducing a transparent, supplementary measure to the Risk Based Capital (“RBC”) requirements for Banks. Further, the ACLI fully recognizes the important implications for ensuring a global regulatory framework for more resilient banks and banking systems. However, the Revised Leverage Ratio Framework, as written, has the potential of creating several negative market consequences in its attempt to mitigate broader systemic risks.

In particular, we are concerned about the potential impact to the fixed income and derivative markets. Specifically, we believe that large portions of the fixed income and derivatives markets will be impacted from proposed changes to the netting of Securities Financing Transactions (SFTs). Additionally, the Derivatives markets will also suffer a negative impact from the inclusion of collateral in the Exposure Measure. Finally, we believe that the Credit Derivatives markets are likely to be adversely affected from more restrictive off-sets for purchased credit derivatives.

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<sup>1</sup> <http://www.bis.org/publ/bcbs251.pdf>

## II. Discussion

The table below summarizes what we believe are the market impacts from the proposed changes:

Market Sector	Exposure Measure Driver	Expected Market Impact
SFTs	No recognition of netting	<ul style="list-style-type: none"> <li>▪ Reduced depth and liquidity</li> <li>▪ Wider bid-ask spreads</li> <li>▪ Spill over impact to all fixed income markets where market liquidity depends on an efficient and liquid financing market (e.g. Government security and derivatives markets)</li> </ul>
Derivatives	Inclusion of cash collateral	<ul style="list-style-type: none"> <li>▪ Reduced depth and liquidity</li> <li>▪ Wider bid-ask spreads</li> <li>▪ At odds with global derivatives reform requirements</li> </ul>
Credit Derivatives	Limited netting of written credit derivatives	<ul style="list-style-type: none"> <li>▪ Reduced depth and liquidity</li> <li>▪ Wider bid-ask spreads</li> </ul>

### (A) Securities Financing Transactions (SFTs)

The Revised Leverage Ratio Framework proposes the inclusion of SFTs on a gross basis, with the removal of accounting netting. We strongly believe that dis-allowing exposure netting for SFTs will have a profound negative impact on the financial markets that depend on these types of transactions, including Repurchase and Reverse Repurchase Transactions, for short and intermediate term financing. Specifically, we believe that this proposed change to the Revised Leverage Ratio will drastically reduce the depth and liquidity of these markets, increase the costs of short and intermediate term financing by increasing the bid-ask spreads for these transactions and ultimately reduce the liquidity in the fixed income markets for the securities underlying these financing transactions, specifically the market for U.S. Government Securities.

SFTs strengthen the Government Securities markets by significantly deepening the liquidity of those securities and allowing brokers to efficiently fulfill their role as primary dealers while cost effectively maintaining a lower level of inventory in these securities. The proposed removal of exposure netting would discourage dealers from engaging in these SFTs of Government Securities with each other, thereby disrupting the efficient allocation of these resources to the best uses. The result of this proposed modification would be a dramatically reduced dealer willingness to facilitate SFT transactions, causing a drop in liquidity and a widening of bid/ask spreads on highly liquid assets (such as U.S. Treasuries). Moreover, reducing the liquidity for these securities will ultimately increase the volatility in bond yields across the broader fixed income markets.

It is worth noting that the U.S. Treasury has \$11Tn of debt outstanding. The daily trading volume of U.S. Treasuries is over \$500Bn, making it one of the deepest and most liquid sectors in the marketplace. Further, U.S. Treasuries have proven to be the safest and soundest asset class during a crisis period. The proposed treatment of SFTs and the resulting penalization for holding high quality liquid assets (HQLA) is at odds with Basel III liquidity framework's Liquidity Coverage Ratio (LCR), which is designed to ensure that banks maintain a resilient liquidity risk profile and hold an adequate stock of unencumbered HQLA

The liquidity impact on the broader fixed income markets would be negative to the core investment holdings of ACLI members. U.S. Treasury securities are used by insurers for a myriad of reasons including core investments, the management of liquidity and duration in their portfolio, asset liability management and fulfillment of collateral requirements for borrowing and hedging activities. The proposed treatment of SFTs discourages financial intermediaries from holding HQLA such as Treasuries, and potentially dissuades Primary Dealers from participating in Treasury market auctions. This could result in a shift in the depth and breadth of the U.S. Treasury market resulting in wider bid/ask spreads, a reduction in liquidity and potentially broader consequences for the global financial markets.

### **(B) Derivatives**

The Revised Leverage Ratio includes cash collateral obtained in respect of derivatives transactions in the Exposure Measure. The ACLI believes that the exchange of high quality collateral (particularly cash) in connection with derivatives transactions is systemically risk reductive and should be encouraged rather than discouraged. Including cash collateral in the Exposure Measure creates a strong disincentive for derivatives market making activities because the associated capital charges will become prohibitive, thereby impacting the liquidity in these markets. This condition will likely increase the costs of hedging by end-users, or potentially force them to abandon the appropriate use of derivatives to prudently hedge market risks. Further, including cash collateral in the Exposure Measure may lead to a reduction of the use of cash collateral to satisfy margin requirements for non-centrally cleared derivatives. Reduced liquidity in the Treasury markets combined with the inclusion of cash collateral in the Exposure Measure will lead to increased costs for market participants.

ACLI members regularly use derivative instruments (including Credit Derivatives) to responsibly and effectively hedge the risks associated with their investment portfolios and insurance and annuity product liabilities. The insurance industry's continued ability to manage and hedge financial risk through the use of derivatives is an essential component of its risk management program.

### **(C) Credit Derivatives**

The Revised Leverage Ratio stipulates a number of requirements that need to be met in order for a Financial Institution to be able to offset credit derivative positions referencing the same entity. Among these, the requirement that the purchased credit default swap must be longer in maturity than the remaining maturity of the written credit default swap appears to be particularly onerous. A purchased credit default swap that is shorter in maturity than a sold credit default swap referencing the same entity provides significant risk reduction, though not 100%, especially in the event of a default of the reference entity. The additional requirements of the proposal targeting credit derivatives would likely have the effect of widening bid-ask spreads and reducing liquidity in that market for buy-side participants.

ACLI members use credit derivatives to manage the credit risk of their investment portfolios. Having the ability to use credit derivatives to manage credit risk is a central component of their overall investment portfolio strategies. The inability to proportionally net written and purchase credit derivatives exposure by derivatives market makers will ultimately decrease liquidity in this market and increase costs which will impair ACLI members' ability to execute their portfolio strategies.

### **III. Proposed Modifications**

The ACLI understands that the Basel III reform introducing a simple, transparent, non-risk based leverage ratio is intended as a credible supplementary measure to RBC requirements. We also understand that the leverage ratio is intended to restrict the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. However, as described above, we believe that certain aspects of the proposal will significantly impair market functionality, liquidity and transaction costs in markets that the insurance industry relies upon. Accordingly, we respectfully suggest that the Committee consider the following modifications:

- Continued allowance of netting for Securities Financing Transactions when the underlying securities consist of Government Securities;
- Exclusion of cash collateral posted or received in connection with derivatives transactions; and
- Recognition of maturity mismatches on a proportional basis in respect of credit derivatives.

### **IV. Conclusion**

The ACLI would like to reiterate our appreciation for the thoughtful approach that the Basel Committee on Banking Supervision has taken regarding the Leverage Ratio calculation. We are pleased to be able to continue to participate through the comment process and respectfully submit that certain aspects discussed above have the potential to unintentionally reduce market liquidity and increase costs in the fixed income and derivative markets. We believe that failure to modify the items listed above will unnecessarily increase costs to ACLI members and their customers.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,



Carl B. Wilkerson