Basel III leverage ratio framework

Response to consultation issued 25 April 2016

23 June 2016
Dear members of the Basel Committee,

The firm of Thomas Murray welcomes the opportunity to comment on possible revisions to the Basel III leverage ratio framework, with specific reference to the treatment of client clearing (point II.1.2).

The firm

Thomas Murray is a private company registered in the United Kingdom, and founded 22 years ago. It is owned by 90 individual investors; there is no institutional tie of any kind, assuring the independence of viewpoint that is essential for credible analytical and advisory services.

Uniquely, the firm’s business is focused on capital markets infrastructure institutions. Its analyses cover 430+ such establishments in more than 100 marketplaces. The question which led to the founding of Thomas Murray was global custody, and from there the business coverage spread by geography and line of business. In addition to monitoring CCPs, today the firm’s assessments cover central securities depositories, custodians (global, national, and sub-custodian), transfer agents, prime brokers, cash correspondent banks as well as clearing houses. 75 persons work for the group, and we endeavour to provide current, detailed information to our clients.

The firm’s work in central counterparty clearing assessments

Launched in 2012, Thomas Murray’s CCP risk assessment programme has led to a considerable deepening of the firm’s expertise in the subject of clearing, notably at a time when OTC contracts were being directed into this space and fundamentally altered the previous ways of
managing portfolios. The programme was launched at the request of global banking clients, and with their backing. It has been clear since the 2009 G20 Pittsburgh summit that the policy expectations in terms of capital markets risk management were changing, possibly more so in the clearing field than in any other market segment.

At the start, the central question posed by clearing members was what their potential liabilities might be if a fellow member were to fail, and they also asked to learn more about how CCPs were being managed. Financial risk, liquidity risk, operational risk, the size of the default fund, the management of collateral: suddenly, one began to look again and differently at many specific aspects of clearing house functioning.

Our clients also requested the firm’s assistance in projecting forward what the commercial outlook might be when the regulatory changes, then being written, would come into effect; and also what their increasing capital requirements might be as participants.

One of the striking results from this work is continuing discomfort as to the cut-off for mandatory clearing of “standardised OTC contracts.” The firm’s clearing member clients wanted to know what exactly a “standardised OTC contract” looks like. They also questioned how the great mass of uncleared, purely bespoke OTC immediately nearby might affect the regulated public markets, with the unknowable influence of its values and counterparty positions. As a firm, we look forward to the day when workable trade repositories will provide regulators and the market with usable information. The interactions of price formation amongst cash securities markets, exchange-traded derivatives, centrally cleared “standardised” OTC derivatives, and uncleared, bespoke OTC contracts results a constantly fluctuating mix that makes valuations and market depth hard to establish. The uncertainty thus created is central to the risk management questions at hand.

Thomas Murray believes that its extensive knowledge of financial markets infrastructures generally, and of CCPs in particular, may give weight to the comments which follow.


Thomas Murray appreciated the opportunity to testify on the several forms of central counterparty clearing risk it assesses in CCPs around the world, and to do so early in this Basel Committee review process when this current paper was being prepared.

Because the details do matter, for this testimony the signatories below were joined by the Capital Markets Technical Manager from IFRS to review how the accounting entries are made for clearing. *Our request to IFRS was to look at the accounting treatment with specific reference to leverage*, which is the main policy instrument available to BCBS in this regard. The point to emphasise was that as the debits and credits are entered in the accounts, reflecting the movement of transaction positions and corresponding cash and securities movements, the
Supplementary Leverage Ratio component of Basel III did not seem to fit the regulatory purpose, for us or for the IFRS expert.

When presenting to the Committee’s hearing last year, this firm supported others testifying who were already questioning the effects of this way of counting initial margin in the Basel III framework. It was already having the harmful effect of making clearing uneconomical, precisely at a time when there is a regulatory imperative to send more transactions into CCPs for the benefit of risk reduction that the mutualisation of risk provides. Since then, the firm has seen more of the real impact of this leverage calculation, with certain institutional investor clients requesting assistance in selecting new clearing brokers due to the incumbents becoming unviable options.

Comments on the current consultation

The Basel III ratios are a pillar of the world’s financial system. One of the authors of this letter remembers speaking with Peter Cooke at length about what was then the Cooke Committee Ratios, including why they were called for, and what they hoped to achieve. We salute the achievements of central bankers since the 1980s in encouraging bank competition on a more level playing field, whilst at the same time assuring that there is sufficient capital in the system to back prudent lending and capital market risk positions. Clearly, for multiple reasons the Basel risk ratios did not work as well as we would have hoped in 2007-2009, but that does not diminish the importance of the objective and the need to correct course.

Our concerns continue to be those that we expressed at the BCBS hearing last year: prudential regulation that makes sense in the banking sector does not suit the needs of the capital market environment. Moreover, as written, Basel III undermines the equally important regulatory goal of encouraging central client clearing for over-the-counter derivatives transactions. These, according to BIS statistics, continue to proliferate.

The posting of initial margin means that the administration of OTC trades already incurs increased costs, which we believe are appropriate and sufficient for managing counterparty risk. The capital set aside for client clearing does reduce risk: it cannot be used by the CCPs, aside from for the purpose of managing a clearing member default in line with their procedures outlined in their rulebook, due to careful, audited segregation. Equally, this collateral is segregated from the clearing member, should it go into default. The Committee appears to be assuming that client initial margin is immaterial in this regard, and in our judgment this is why setting the ratio in this way gets it wrong.

As increased capital costs set against OTC contracts begin to be felt more keenly in the course of 2016, this should lead to less use of bespoke OTC derivatives. This is, in our view, appropriate and healthy for the financial system, given the extensive offer of on-exchange, centrally cleared
contracts available for very largely the same economic purposes. Their use lowers the risk profile of the transactions. In this sense, the capital charge will have the right effect.

But let us not bring harm to the basic functioning of central clearing, which is the use of these infrastructures to mutualise, and so lower, risk to the market. If uncorrected, the Basel Leverage Ratio’s current treatment of initial margin would further and unnecessarily increase costs for the legitimate use of CCPs in handling exchange-traded and standardized OTC derivatives, thereby reducing access for end-users. Also, if maintained as now written, the costs of complying with the ratio would likely lead to even fewer clearing members in the market, and that number has already been falling dramatically over the past several years precisely at the time when more investors need access to them. Losing significant numbers of clearing members underscores the poor commercial prospects afforded by being in business in this segment – this exodus is a signal that the authorities should also heed. It also has the additional deleterious effect of concentrating clearing risk amongst a smaller number of clearing banks.

Investors are also being asked to line up alternative clearing members to cover the potential requirement to port positions, increasing the demand on a decreasing supply. Taken together, whatever the mathematics, the capital cost is likely to impair the liquidity and portability of clearing members’ derivatives portfolios, particularly in times of crisis, and therefore would increase systemic risk.

Put differently,

- The Total Leverage Exposure in the denominator of the Basel Leverage Ratio is intended to capture a bank’s actual economic exposure to losses that could arise from its client clearing activities.
- Initial client 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 bank absorbs any losses related to that client’s transaction with the CCP.
- As a result, the actual economic exposure of the bank to the CCP arising from the bank’s guarantee of the client’s obligation to the CCP should always reflect the exposure-reducing effect of initial margin.

**Conclusion**

The world economy and financial system require coherent, consistent information and risk management of OTC contracts. The G20 has gone some of the way towards enhancing transparency with transaction reporting to newly-created infrastructures called trade repositories; establishing dedicated platforms for trading standardised contracts; and through capital charges pushing more contracts into central clearing.
The G20 has also assured that market infrastructures like CCPs are properly managed, notably with the CPMI-IOSCO Principles; and also are well capitalised to meet the potential demands of very adverse market conditions.

It should be remembered that CCPs around the world met their obligations to the market by clearing daily through the crises of 2007-2009, though in those years without significant direct exposure to OTC derivatives. The introduction of these contracts since then has complicated the management of the risk mix quite considerably.

Simply put, the portion of the Basel ratio directly related to clearing risk is unnecessary and uneconomic, and it will continue to hinder access to central clearing. In our view, that will add to systemic risk, not reduce it.

We remain respectfully yours for questions you may have,

Sincerely,

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