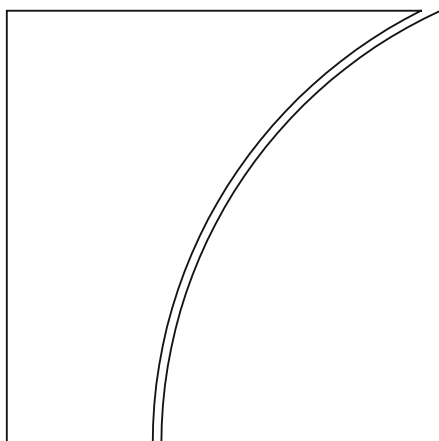


Basel Committee on Banking Supervision



Frequently asked questions on the Basel III leverage ratio framework

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Introduction

In January 2014, the Basel Committee on Banking Supervision (“the Committee”) published the Basel III leverage ratio framework¹ together with the public disclosure requirements applicable as of 1 January 2015. To promote consistent global implementation of those requirements, the Committee has agreed to periodically review *frequently asked questions* (FAQs) and publish answers along with any technical elaboration of the standards text and interpretative guidance that may be necessary.

Since publication, the Committee has received numerous FAQs with respect to the published standards text. This document sets out the first and second set of FAQs that relate to the Basel III leverage ratio framework. The questions and answers are grouped according to different relevant areas, which are in the order (i) criteria for the recognition of cash variation margin associated with derivative exposures (section 1); (ii) centrally cleared client derivative exposures (section 2); (iii) exposures and netting of securities financing transactions (SFTs) (section 3); (iv) the treatment of netting of SFTs and derivatives under a *cross-product* netting agreement (section 4); (v) the exposure measure under the additional treatment for credit derivatives (section 5); and (vi) the treatment of long settlement transactions and failed trades. FAQs that have been added since the publication of the previous version of this document in October 2014 are shaded **yellow**.

1. FAQs related to the recognition of cash variation margin

1.1. Interpretation of the currency of settlement requirement

Q1. *Under paragraph 25(iii), cash variation margin received must be in the same currency as the currency of settlement of the derivative contract. What does currency of settlement mean?*

Relevant provisions: paragraph 25(iii) of the Basel III leverage ratio framework.

Answer: For purposes of paragraph 25(iii) of the Basel III leverage ratio framework, currency of settlement means any currency of settlement specified in the derivative contract, governing qualifying master netting agreement (MNA), or the credit support annex (CSA) to the qualifying MNA.²

The above answer should be considered an interim response. The Committee will undertake a more detailed analysis of this interpretation and the consequences of paragraph 25(iii) of the Basel III leverage ratio framework, including issues arising from foreign exchange risk due to currency mismatches between the market value of the derivatives and the associated cash variation margins.

¹ *Basel III leverage ratio framework and disclosure requirements* (January 2014) (www.bis.org/publ/bcbs270.htm).

² To the extent that the criteria in this paragraph include the term *master netting agreement*, this term should be read as including any *netting agreement* that provides legally enforceable rights of offsets. This is to take account of the fact that for netting agreements employed by CCPs, no standardisation has currently emerged that would be comparable with respect to OTC netting agreements for bilateral trading.

1.2. Legal enforceability and effectiveness of a master netting agreement (MNA)

Q2. What standards are banks expected to meet for master netting agreements (MNA) to be legally enforceable and effective?

Relevant provisions: paragraph 25(v) of the Basel III leverage ratio framework.

Answer: A master netting agreement (MNA) is deemed to meet this criterion if it satisfies the conditions in paragraphs 8(c) and 9 of the Annex to the *Basel III leverage ratio framework and disclosure requirements*.

1.3. Daily calculation and exchange of cash variation margin

Q3. The condition that cash variation margin must be calculated and exchanged on a daily basis may not be met for certain types of cleared derivatives (eg energy derivatives). Will any exception for the daily calculation/exchange requirement be permitted for these types of CCPs?

Relevant provisions: paragraph 25(ii) of the Basel III leverage ratio framework.

Answer: To meet this criterion, derivative positions *must* be valued daily and cash variation margin *must* be transferred daily to the counterparty or to the counterparty's account, as appropriate.

1.4. Exchange of cash variation margin on the subsequent morning

Q4. In the case where cash variation margin is exchanged the next morning to meet end-of-day market values, would the requirement of paragraph 25(iv) still be met?

Relevant provisions: paragraph 25(iv) together with paragraph 25(ii) of the Basel III leverage ratio framework.

Answer: Cash variation margin exchanged on the morning of the subsequent trading day based on the previous, end-of-day market values would meet this criterion, provided that the variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to applicable threshold and minimum transfer amounts.

1.5. Non-segregation of cash variation margin

Q5. What is meant in paragraph 25 when stating that the cash received by the recipient counterparty is not segregated?

Relevant provisions: paragraph 25(i) of the Basel III leverage ratio framework.

Answer: Cash variation margin would satisfy the *non-segregation* criterion if the recipient counterparty has no restrictions on the ability to use the cash received (ie the cash variation margin received is used as its own cash).

Q6. Where a bank provides cash variation margin it would not necessarily have any knowledge of whether its counterparty has segregated the cash or not. What standard would need to be met to fulfil this criterion?

Relevant provisions: paragraph 25(i) of the Basel III leverage ratio framework.

Answer: This criterion would be met if the cash *received* by the recipient counterparty is not required to be segregated by law, regulation, or any agreement with the counterparty.

1.6. Calculation of the net-to-gross ratio (NGR)

Q7. *Paragraph 26 mentions that cash variation margin may not be used in the calculation of NGR. Is this also in the case when the conditions of paragraph 25 are met?*

Relevant provisions: paragraphs 25 and 26 of the Basel III leverage ratio framework together with paragraph 10 of the Annex of the Basel III leverage ratio framework.

Answer: Cash variation margin may not be used to reduce the *net-to-gross ratio* (NGR), even if the conditions in paragraph 25 are fully met. Specifically, in the calculation of the NGR, cash variation margin may not reduce the net replacement cost (ie the numerator of the NGR), nor the gross replacement cost (ie the denominator of the NGR).

2. Client-clearing of affiliated entities' trade exposures

Q1. *Can an affiliate entity to the bank acting as a clearing member be considered a client in the sense and for the purposes of paragraph 27?*

Relevant provisions: paragraph 27 of the Basel III leverage ratio framework.

Answer: An affiliated entity to the bank acting as a clearing member (CM) may be considered a *client* for the purpose of paragraph 27 of the Basel III leverage ratio framework if it is outside the relevant scope of regulatory consolidation at the level at which the Basel III leverage ratio is applied. In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation, but the CM still has a trade exposure to the qualifying central counterparty (QCCP), which will be considered *proprietary* and the exemption in the said paragraph 27 no longer applies.

3. Exposures and netting of securities financing transactions (SFTs)

Q1(a). *Paragraph 33(i)(c) requires that the linkages to collateral flows between a reverse repo and repo settled on the same day not result in the unwinding of net cash settlement. What is meant by this requirement and what is the standard for meeting it?*

Q1(b). *How should one interpret footnote 22? Could you provide further clarity on this point, and examples of settlement system facilities that would be acceptable to qualify for netting and any that would not?*

Q1(c). *Can the Basel Committee define in more detail what is meant by 'net settlement' as described in paragraph 33(i)(c)? More specifically, does a transaction that has 'failed' impact the ability for that transaction to be netted?*

Relevant provisions: Paragraph 33(i)(c) and footnote 22 of the Basel III leverage ratio framework.

Answer: Paragraph (33)(i)(c) and footnote 22 set out necessary requirements for settlement mechanisms which are used to settle cash payables and cash receivables in securities financing transactions (SFTs) with the same counterparty in order to offset the cash payables against the cash receivables. Subject to criteria 33(i)(a) and 33(i)(b) also being met, the requirements are that the transactions are subject to a settlement mechanism that results in the functional equivalence of net settlement, ie the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date. To achieve such

equivalence, all transactions must be settled through the same settlement mechanism. The failure of any single securities transaction in the settlement mechanism should delay settlement of only the matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility.

Further to the requirements set out in paragraph (33)(i)(c) and footnote 22, if there is a failure of the securities leg of a transaction in such a mechanism at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross for the purposes of the Basel III leverage ratio exposure measure.

Specifically, the criteria in paragraph (33)(i)(c) and footnote 22 are not intended to preclude a *Delivery-versus-Payment* (DVP) settlement mechanism or other type of settlement mechanism, provided that the settlement mechanism meets the functional requirements set out in paragraph 33(i)(c). For example, a settlement mechanism may meet these functional requirements if any failed transaction (that is, the securities that failed to transfer and the related cash receivable or payable) can be re-entered in the settlement mechanism until they are settled.

Q2. *How should SFTs with no explicit end date but which can be unwound at any time by any counterparty be treated?*

Relevant provisions: paragraph 33(i)(a) of the Basel III leverage ratio framework.

Answer: An SFT with no explicit end date but which can be unwound at any time by any counterparty (eg open repos) are not eligible for Basel III leverage ratio netting of SFTs as they do not meet the condition set out in paragraph 33(i)(a). This condition requires that, for Basel III leverage ratio netting, transactions must have the same explicit final settlement date.

Q3. *The Basel III leverage ratio framework refers to the “final contractual exposure” as a replacement for “gross SFT assets recognised for accounting purposes” for SFT assets cleared through qualifying central counterparties (QCCPs). Could you please define “final contractual exposure”?*

Relevant provisions: paragraph 33(i) and footnote 19 of the Basel III leverage ratio framework.

Answer: “Final contractual exposure” as set out in footnote 19 of the Basel III leverage ratio framework refers to the exposure to the QCCP after the process of novation has been applied. However, banks can only net cash receivables and cash payables with a QCCP if the criteria in paragraph 33(i) are met. Any other netting permitted by the QCCP is not permitted for purposes of the Basel III leverage ratio.

4. Netting under the Basel III leverage ratio framework for derivatives and SFTs in the presence of cross-product netting agreements

Q1. *How should banks perform netting under the leverage ratio for derivatives and SFTs that are included in a cross-product netting agreement?*

Relevant provisions: footnote 7 of the Basel III leverage ratio framework.

Answer: Consistent with footnote 7 of the Basel III leverage ratio framework, netting across product categories (ie derivatives and SFTs) is not permitted for the purposes of determining the Basel III leverage ratio exposure measure. However, where a bank has a cross-product netting agreement in place that meets the eligibility criteria of paragraphs 8 and 9 of the Annex of the Basel III leverage ratio framework, it may choose to perform netting separately in each product category provided that all other conditions for netting in this product category that are applicable to the Basel III leverage ratio are met.

5. The meaning of a *negative change in fair value*

Q1. *What is meant by negative change in fair value in paragraph 30 of the Basel III leverage ratio framework?*

Relevant provisions: Paragraph 30 of the Basel III leverage ratio framework.

Answer: A negative change in fair value is meant to refer to a negative fair value of a credit derivative that is recognised in Tier 1 capital. This treatment is consistent with the Committee's communicated rationale that the effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, which means the maximum potential loss at the reporting date is the notional amount of the credit derivative minus any negative fair value that has already reduced Tier 1 capital.

For example, if a written credit derivative had a positive fair value of 20 on one date and has a negative fair value of 10 on a subsequent reporting date, the effective notional amount of the credit derivative may be reduced by 10. The effective notional amount cannot be reduced by 30. However, if at the subsequent reporting date the credit derivative has a positive fair value of 5, the effective notional amount cannot be reduced at all.

6. Treatment of long settlement transactions and failed trades

Q1. *How should long settlement transactions (LSTs) and failed trades be treated in the Basel III leverage ratio?*

Relevant provisions: paragraph 12 of the Basel III leverage ratio framework.

Answer: LSTs and failed trades are terms that are in use in the Basel II capital framework. For the purposes of the Basel III leverage ratio framework these transactions have to be treated according to their accounting classification. For example, if an LST is classified as a derivative according to the applicable accounting standards the Basel III leverage ratio exposure measure has to be calculated according to paragraphs 18 to 28 on "derivative exposures". Similarly, if a failed trade is classified as a receivable according to the applicable accounting standards the exposure measure has to be calculated according to paragraphs 15 to 17 related to "on-balance sheet exposures". SFTs that have failed to settle are excluded from the described treatment and their exposure measure must be calculated according to paragraphs 32 to 37 on "securities financing transaction (SFT) exposures".