



asset management group



MANAGED FUNDS
ASSOCIATION

January 15, 2019

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Response to Consultative Document: Leverage Ratio Treatment of Client Cleared Derivatives (BCBS d451)

Dear Sirs and Madams:

The Securities Industry and Financial Markets Association’s Asset Management Group (“**SIFMA AMG**”) and Managed Funds Association (“**MFA**”)¹ write to respond to the Basel Committee’s consultative document on the leverage ratio treatment of client cleared derivatives (the “**Consultation**”).² SIFMA AMG members, on behalf of their clients, and MFA members use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge investment risks such as changes in interest rates, exchange rates, and commodity prices. We support the adoption of a targeted and limited revision of the leverage ratio to recognize the effect of initial margin provided by a client in a client cleared derivative transaction in reducing the exposure of the bank acting as clearing member.

Central clearing of derivatives is intended to reduce counterparty risk, promote market stability, and enhance transparency. However, since its adoption in 2014, the leverage ratio has significantly impaired the full realization of these benefits by reducing market liquidity, imposing barriers to access clearing, and increasing systemic risk. Data provided in this letter shows that SIFMA AMG member clients have experienced reduced access to clearing services and higher clearing fees resulting from the implementation of the leverage ratio. We also have serious concerns that in the event of market-wide stress, the leverage ratio would significantly disincentivize banks from acquiring a failing clearing member’s book of client positions through a “port,” which would leave clients exposed and without access to clearing services.

Section I of this letter describes the leverage ratio’s current overstatement of a bank’s exposure arising from client clearing. Section II provides empirical evidence that this overstatement of exposure has harmed end users of cleared derivatives, thus “warrant[ing] a revision to the leverage ratio treatment of client cleared derivatives to recognize the exposure-reducing effect of initial margin.” Section III explains why such a revision would decrease systemic risk and therefore “adequately meet the G20 Leaders’ policy objectives of strengthening the resilience of the banking system by preventing excessive leverage and promoting central clearing of standardized derivative contracts.” Finally, section IV describes why Option 3 of the Consultation would be more consistent with G20 Leaders’ goals than Options 1 and 2.

¹ See Annex A for descriptions of SIFMA AMG and MFA.

² Basel Committee on Banking Supervision, Leverage Ratio Treatment of Client Cleared Derivatives (Oct. 18, 2018), available at <https://www.bis.org/bcbs/publ/d451.htm>.

I. By Failing to Recognize the Exposure-Reducing Effect of Initial Margin Provided by a Client, the Leverage Ratio Overstates a Bank's Actual Economic Exposure From Derivatives Clearing

Derivatives clearing for clients is fundamentally a low-exposure and, historically, low-return business for banks. When a clearing member bank acts as agent for a client's centrally-cleared OTC derivative transaction, and guarantees the client's performance to a central counterparty ("CCP"), the probability and extent to which the bank will be required to step in and make a payment to the CCP is substantially mitigated by variation and initial margin posted by the client, for the following reasons:³

- The client is required to post cash variation margin in the amount necessary to settle the entire amount of any deficiency related to the market value of the derivative. The amount of variation margin transferred is adjusted daily to reflect the current mark-to-market value of the position.
- The client is also required to post robust amounts of initial margin at all times. For example, in the United States, Commodity Futures Trading Commission ("CFTC") regulations and CCP rules require the client to post an amount of initial margin to cover the CCP's exposure, meaning an amount of assets that would cover a loss with an established confidence level of at least 99 percent.⁴
- Initial margin is required by law and CCP rules to be held in the form of extremely highly liquid assets and to be segregated from the bank's own assets. Because the initial margin is so liquid and is segregated, it is available to offset the amount that the bank would be required to pay the CCP in the event that the client defaulted. Additionally, the bank's margin and risk management programs are highly regulated. In the U.S., for instance, the CFTC imposes regular reporting and notification requirements related to margin deficiencies.
- The bank is only economically "on the hook" to the extent the client defaults and the amount the client owes is not covered by its initial margin and variation margin, both of which are addressed daily by margin calls. Even though the bank's guarantee covers the entire amount of the client's default, the liquid margin available to the bank or CCP ensures that the economics are the same as if the bank's guarantee covered the amount of the client's default net of margin.

As a result, variation and initial margin plainly reduce the bank's economic exposure arising out of its guarantee to the CCP.

Yet, the leverage ratio currently fails to recognize the exposure-reducing effect of initial margin. Instead, a bank that clears a derivative for its client is required to calculate its leverage exposure arising out of its guarantee to the CCP as if the client had not posted *any* initial margin. This result is at odds with economic reality – the bank's *leverage exposure* for the transaction grossly exceeds its *actual economic exposure*. And this result is inconsistent with the leverage ratio's practical and appropriate treatment of securities financing transactions, whereby a bank acting as agent for a client and providing a guarantee of its

³ Client margin likewise reduces the probability and extent to which a bank will need to step in to make the CCP whole in the event of a client default in the "principal-to-principal" or "financial intermediary" model of clearing that is used in certain jurisdictions.

⁴ See 17 C.F.R. § 39.13(g)(2)(iii).

client's transaction is permitted to deduct from its leverage exposure the amount of collateral posted by the client.⁵

II. Evidence from End Users Warrants a Revision to the Leverage Ratio to Recognize the Exposure-Reducing Effect of Initial Margin Provided by a Client

The leverage ratio's substantial overstatement of a bank's actual economic exposure in a cleared derivative transaction has disincentivized banks from providing clearing services to SIFMA AMG members and their clients and MFA members. As a result, SIFMA AMG members and their clients and MFA members have faced reduced access to clearing services and have paid higher prices for such access, or expect such adverse consequences without an appropriate revision to the leverage ratio.

In June 2016, SIFMA AMG conducted a survey of its members to determine the effect of the leverage ratio's failure to recognize the exposure-reducing effect of initial margin on their ability to access clearing services for clients. Twelve SIFMA AMG members responded to the survey, representing an aggregate of over \$1 trillion in assets under management.⁶ SIFMA AMG believes that if it were to conduct this survey again, the results discussed below would not change significantly and may even show a greater negative impact of the leverage ratio on its members and their clients, given that the leverage ratio became a binding minimum requirement on January 1, 2018.

The survey revealed the following results:

Reduced Access to Clearing Services

SIFMA AMG's survey indicated that its members have had reduced access to cleared derivatives since the introduction of the leverage ratio. For example, a significant number of the survey respondents had been asked to agree to a cap (*i.e.*, a limit on their clients' use of derivatives) on outstanding positions, as reflected in the following table:

Percentage of Respondents That Have Been Asked to Agree to a Cap on Outstanding Positions				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
33%	30%	50%	13%	55%

Some SIFMA AMG members had been forced by their clearing member to terminate clearing relationships (and seek clearing elsewhere, if possible), as reflected in the following table:

Percentage of Respondents That Have Terminated Clearing Relationships Involuntarily				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
8%	10%	30%	25%	18%

These results are consistent with clients' survey responses to the 2018 qualitative survey of the international standard-setting bodies' Derivatives Assessment Team. The Derivatives Assessment Team's

⁵ See Basel Committee on Banking Supervision, *Basel III: Finalising Post-Crisis Reforms*, p. 153 ¶ 54 (Dec. 2017), available at <https://www.bis.org/bcbs/publ/d424.pdf>. While this treatment is available where a bank's guarantee is legally limited to the difference between the value of the loaned asset and the value of the collateral, a clearing member's guarantee of a client's OTC derivative trade with a CCP is effectively net of initial margin provided.

⁶ See SIFMA AMG Letter to BCBS (June 30, 2016), available at <https://www.sifma.org/wp-content/uploads/2017/05/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-leverage-ratio-framework.pdf>.

final report of November 2018 (the “**DAT Report**”) states that over two-thirds (68 percent) of the 44 clients who responded reported encountering difficulties of some type in accessing clearing services.⁷ According to clients responding to the DAT Report that were off-boarded by a clearing member, the most common reason for such off-boarding was capital constraints that a Basel III requirement imposed on the clearing member.⁸ An overwhelming majority (88.2 percent) of client clearing service providers reported that the leverage ratio, specifically, negatively impacted their ability to offer client clearing services, while nearly-two thirds (64.7 percent) reported a “significant” negative impact.⁹

Higher Prices

Since the introduction of the leverage ratio, clients have had to pay higher clearing fees to access cleared derivatives, as reflected in the following results from SIFMA AMG’s member survey:

Percentage of Respondents That Have Been Asked to Increase Clearing Fees By Product				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
50%	50%	60%	50%	64%

Similarly, SIFMA AMG members have relinquished to their clearing members a greater proportion of income from the reinvestment of posted initial margin:

Percentage of Respondents That Have Relinquished to Their Clearing Members a Greater Portion of Income from the Reinvestment of Posted Initial Margin					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	33%	30%	30%	25%	27%
Securities	8%	10%	10%	0%	9%

A substantial number of SIFMA AMG members had been asked by their clearing member to reroute execution business to it, that is, in order to avoid larger increases in clearing fees, to use the same firm for both trade execution and as their clients’ clearing account holder. It is common for SIFMA AMG members to use one or more firms for execution, and separate firms for the clearing accounts of the entity the SIFMA AMG member is managing. Clients pay separate fees for clearing and for execution of derivatives. In the United States, investment advisers acting as fiduciaries have an obligation to obtain “best execution” for clients’ transactions, meaning that the terms for each client transaction generally must be the most favorable terms reasonably available under the circumstances.¹⁰ As a result, SIFMA AMG members often must accept higher *clearing* fees for their clients to obtain lower *execution* fees:

⁷ See Derivatives Assessment Team, Incentives to Centrally Clear Over-the-Counter (OTC) Derivatives: A Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms – Final Report, at p. 49 (Nov. 19, 2018), available at <http://www.fsb.org/2018/11/fsb-and-standard-setting-bodies-publish-final-report-on-effects-of-reforms-on-incentives-to-centrally-clear-over-the-counter-derivatives> (“Some smaller clients and some of those with more directional portfolios report experiencing difficulties gaining and/or maintaining access to central clearing.”).

⁸ *Id.* at pp. 49-50.

⁹ *Id.* at p. 65.

¹⁰ Securities Brokerage and Research Services, Release No. 34-23170 (Apr. 23, 1986); In the Matter of Kidder, Peabody & Co., Inc., et al., Investment Advisers Act Release No. 232 (Oct. 16, 1985); Securities Exchange Act Release No. 12251 (Mar. 24, 1976); Securities Exchange Act Release No. 9598 (May 9, 1972).

Percentage of Respondents That Have Been Asked to Reroute Execution Business to Avoid Larger Increases in Clearing Fees				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
58%	50%	40%	25%	27%

SIFMA AMG members have experienced higher fees particularly where they post initial margin in the form of cash:

Percentage of Respondents That Have Been Charged Increased Fees for Posting Initial Margin					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	42%	40%	40%	13%	27%
Securities	17%	10%	20%	0%	9%

We believe these results establish that the leverage ratio has been a *direct cause* of the increase in client fees. Despite the fact that cash is the safest and most liquid form of margin, our members' experience has been that some clearing members prefer not to have clients post margin in the form of cash. Banks acting as clearing members often prefer initial margin to be in the form of securities because under operative accounting standards, cash initial margin posted to a bank is generally reflected on the bank's balance sheet, which adds to the bank's total leverage exposure under the leverage ratio. Consistent with these results, the DAT Report states that all but one client clearing service provider that have adjusted fees cited regulatory capital costs as the reason.¹¹

Moreover, clients that use derivatives solely for risk management purposes rather than speculation – including pension funds, mutual funds, and life insurance companies – tend to have smaller, more directional, and longer-term derivatives portfolios, and use less active trading strategies. These attributes make such clients' trades particularly disadvantaged under the leverage ratio denominator. Consequently, these clients have been disproportionately harmed by the leverage ratio and its failure to recognize the exposure-reducing effect of initial margin.¹²

III. Recognizing the Exposure-Reducing Effect of Initial Margin Provided by a Client in a Cleared Derivative Transaction Would Decrease Systemic Risk and Strengthen the Resilience of the Banking System, Consistent with the G20 Leaders' Goals

Since the Basel Committee introduced the leverage ratio in 2010, and particularly since banks began reporting their leverage ratios to their national supervisors in 2013, a series of large banks have shut down their client clearing businesses in some or all markets around the globe,¹³ and banks have not newly entered

¹¹ See DAT Report at p. 51.

¹² See DAT Report at p. 3 (“Some smaller clients and some of those with more directional portfolios report experiencing difficulties gaining and/or maintaining access to central clearing.”).

¹³ See Deutsche Bank Walks Away From US Swaps Clearing, Financial Times (Feb. 9, 2017), available at <https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655>; Nomura Exits Swaps Clearing for US and European Customers, Financial Times (May 12, 2015), available at <https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de>; State Street Exiting Swaps Clearing Business, Citing New Rules, Bloomberg (Dec. 4, 2014), available at <https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules>; RBS to Wind Down Swaps Clearing Units, Reuters (May 19, 2014), available at <http://uk.reuters.com/article/uk-rbs-primeservices-divestiture-idUKKBN0DY0PU20140519>; BNY Mellon Closes U.S. Derivatives Clearing Business, Pension & Investments (Dec. 20, 2013), available at <http://www.pionline.com/article/20131210/ONLINE/13121993/bny-mellon-closes-us-derivatives-clearing-business>. Additionally, the Chicago Mercantile Exchange recently withdrew a proposal to establish direct clearing, which could

the clearing business. Indeed, the DAT Report found that just *five* firms, all bank-affiliated, account for over 80 percent of total client margin for cleared interest rate swaps in the United States, United Kingdom and Japan. The DAT Report also found that most clients have a relationship with just a single client clearing service provider, which underscores how vulnerable clients are to the loss of clearing services if another major bank exits the market.¹⁴ We believe the cumulative effect of these market exits and increased concentration has been a substantial reduction in clearing capacity in the market.

It is important to view these market exits in context. Global clearing mandates implementing the Pittsburgh G20 Commitments have required certain swaps that previously were bilateral transactions to be centrally cleared. These mandates have created significant demand for clearing services and have resulted in a dramatic rise in overall clearing volumes in recent years. There has also been substantial end user interest in voluntary clearing of certain non-mandated derivatives. A decrease in the number of firms willing to supply these services due to increased capital costs over the same period underscores just how difficult the leverage ratio has made it for banks to continue to clear derivatives for clients.

Given current levels of concentration of clearing members, SIFMA AMG and MFA have serious concerns about the systemic risk potentially posed by such concentration, as well as the portability of a failing clearing member's book of cleared derivatives to other clearing members in times of system-wide stress. In a time of system-wide stress, when capital buffers decline, the leverage ratio is more likely to serve as a binding capital constraint on banks throughout the market. Additionally, in times of stress, CCPs are likely to increase margin requirements, which would indirectly increase banks' capital requirements to the extent clients provide initial margin in the form of cash that goes on banks' balance sheets. In these circumstances, a bank might be required to raise capital in order to acquire a book of cleared derivatives from a failing clearing member, which would make the bank much less willing to step in to acquire the book. The leverage ratio would therefore be pro-cyclical, intensifying market stress at exactly the wrong moment. This pro-cyclical effect is likely to be more pronounced given the small numbers of clearing members currently in the market.

Amending the leverage ratio to recognize the exposure-reducing effect of initial margin in a cleared derivatives transaction would be likely to decrease systemic risk by eliminating a key barrier to porting of client's positions to other banks in times of stress. Effective porting strengthens the resilience of the banking system because it reduces the knock-on effects of a clearing member's default, and because banks of all sizes are themselves clients.¹⁵ Likewise, an amendment to the leverage ratio to recognize the exposure-reducing effect of initial margin in a cleared derivatives transaction would promote access to clearing services by removing a significant disincentive for banks to offer such services.

The Basel Committee and national regulators should also consider additional forms of relief that would mitigate barriers to effective porting. For instance, temporary relief from prescriptive KYC requirements would facilitate other clearing members onboarding the clients of a failing clearing member without any significant lapse in time.

have provided a less capital-intensive pathway to clearing for some of the largest clients. *See* CME Abandons Buy-Side Direct Clearing Initiative, Risk Magazine (Nov. 30, 2018), available at <https://www.risk.net/derivatives/6171461/cme-abandons-buy-side-direct-clearing-initiative>.

¹⁴ DAT Report at p. 19.

¹⁵ *See* DAT Report at p. 17.

IV. Option 3 of the Consultation Would Best Achieve the G20 Commitment of Promoting Central Clearing

The Consultation presents three options that the Basel Committee is considering. Option 1 would not change the leverage ratio in any respect. Option 2 would amend the leverage ratio's treatment of client cleared derivatives to allow cash and non-cash initial margin provided by a client to offset the bank's potential future exposure ("PFE"). Option 3 would align the leverage ratio's treatment of client cleared derivatives with that of the standardized approach for measuring counterparty credit risk exposures in risk-based capital requirements, with the effect of allowing both cash and non-cash forms of initial margin and variation margin provided by a client to offset the bank's replacement cost ("RC") and PFE.

For the reasons discussed above in this letter, Option 1 – maintaining the status quo – undermines the G20 Leaders' goals by depressing clearing capacity, reducing access to clearing, and increasing systemic risk compared to the alternatives. In short, Option 1 would continue to severely prejudice and hamper the hedging capabilities of our members and their clients, and we therefore strongly urge the Basel Committee not to choose this approach.

As between Option 2 and Option 3, both of which would provide an offset for initial margin within the PFE calculation, we believe Option 3 would lead to better outcomes for end users. A key difference between Option 2 and Option 3 is that the latter would allow recognition of non-cash variation margin received from a client, while the former would not. Some types of end users, including many of our members and their clients, have greater amounts of ultralow-risk securities, such as government obligations, than cash in their portfolios. In cleared swaps, variation margin payments made in the form of securities would function as settlement (rather than collateral) and extinguish the bank's exposure daily. But because the leverage ratio does not allow non-cash variation margin to offset a bank's RC, banks generally require their clients to post cash variation margin.¹⁶ To access cash to fund the exchange of variation margin, these clients must liquidate securities, which imposes transaction costs and timing frictions. By recognizing non-cash variation margin posted by a client to the bank as offsetting the bank's RC, Option 3 would eliminate a regulatory disincentive for banks to require clients to post variation margin in the form of cash. As such, Option 3 could allow clients to post margin in a more cost-efficient manner.

Additionally, we understand that Option 3 would lead to somewhat lower leverage exposures for client clearing activity. Given the fragile state of the clearing ecosystem resulting from implementation of the leverage ratio, the Basel Committee should seek to reduce disincentives to clear derivatives to the greatest degree that is consistent with maintaining safety and soundness and reducing systemic risk. We believe adoption of Option 3 would be entirely consistent with these goals.

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¹⁶ Additionally, CCP rulebooks require clearing members to on-post variation margin to the CCP in the form of cash.

Basel Committee on Banking Supervision
January 15, 2019

We appreciate the Basel Committee's consideration of our response. Asset managers' clients have now experienced the serious negative effects of the leverage ratio for years. We urge the Basel Committee to adopt Option 3 of the Consultation to remove disincentives for banks to clear derivatives for their clients.

Should you have any questions, please do not hesitate to contact SIFMA AMG at Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Jason Silverstein at (212) 313-1176 or jsilverstein@sifma.org, SIFMA AMG's counsel at Covington & Burling LLP, Stephen Humenik at (202) 662-5803 or shumenik@cov.com or Randy Benjenk at (202) 662-5041 or rbenjenk@cov.com, or MFA at Michael Pedroni or mpedroni@managedfunds.org or Laura Harper Powell or lharperpowell@managedfunds.org at (202) 730-2600.

Respectfully submitted,

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Annex A

Descriptions of SIFMA AMG and MFA

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed \$45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.