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16 January 2019

**Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland**

### **BCBS Consultative Document: Leverage ratio treatment of client cleared derivatives**

The Global Association of Central Counterparties (“CCP12”) and the European Association of CCP Clearing Houses (“EACH”) welcome the opportunity to provide its response on behalf of our membership to the Basel Committee on Banking Supervision’s (“BCBS”) consultative document Leverage ratio treatment of client cleared derivatives (the “consultation”).

CCP12 is a global association of 36 members who operate more than 50 individual central counterparties (“CCPs”) globally across the Americas, EMEA and the Asia-Pacific region. CCP12 aims to promote effective, practical and appropriate risk management and operational standards for CCPs to ensure the safety and efficiency of the financial markets it represents. Collectively, CCP12 members hold more than \$650 billion US dollar equivalent of initial margin to safeguard the markets they collectively support<sup>1</sup>.

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparty Clearing Houses in Europe since 1992. EACH currently has 20 members from 15 different European countries and is registered in the European Union Transparency Register with number 36897011311-96.

CCP12 and EACH are encouraged that the BCBS has committed to a thorough evaluation of how the application of the Basel III Leverage Ratio (“Leverage Ratio”) has impacted the centrally cleared markets. In November 2018, the Derivatives Assessment Team (“DAT”), a group convened by the Financial Stability Board (“FSB”), the BCBS, the Committee on Payments and Market Infrastructures (“CPMI”), and the International Organization of Securities Commissions (“IOSCO”), concluded that the Leverage Ratio “can be a disincentive for banks to offer or expand client clearing services”<sup>2</sup> and recommended this issue for further analysis. As providers of central clearing services, members of CCP12 and EACH are directly and indirectly impacted by the Basel III reforms, which impact the way market participants utilize our markets and central clearing.

CCP12 and EACH welcome the BCBS consultation and other work previously done by local regulatory authorities and international standard setters on this important topic. We believe such work and market stakeholders’ consistent and coherent concerns demonstrate that appropriate actions should be taken without delay to address the shortcomings of the Leverage Ratio with respect to centrally cleared derivatives. Our more detailed comments are below.

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<sup>1</sup> For further Quantitative Information regarding the Centrally Cleared Markets, please see our CCP12 Quantitative Disclosure Bulletins for summary information, most recent release available here: [http://ccp12.org/wp-content/uploads/2018/11/CCP12\\_PQD\\_Newsletter\\_Nov2018\\_Final.pdf](http://ccp12.org/wp-content/uploads/2018/11/CCP12_PQD_Newsletter_Nov2018_Final.pdf)

<sup>2</sup> <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/>

**Question 1: Is there concrete and robust empirical evidence that would warrant a revision to the leverage ratio treatment of client cleared derivatives?**

Yes, as concluded in the FSB's DAT final report, *Incentives to centrally clear over-the-counter (OTC) derivatives*, client access to the centrally cleared derivatives markets has been impacted directly by the Leverage Ratio's application to the centrally cleared derivatives markets without recognition of the structure of the centrally cleared derivatives market. In centrally cleared derivatives markets, there are two primary methods of obtaining access to the markets: i) as a direct clearing member; and ii) as a client, where a client is commonly a customer of a direct clearing member who acts as an agent to facilitate the customer's access to the centrally cleared market. The relationship a clearing member has under ii) is essentially identical to the "Bank acting as agent" relationship as laid out in paragraph 53 in the Securities Financing Transaction ("SFT") exposures section of the BCBS text: *Basel III: Finalizing post-crisis reforms*, December 2017<sup>3</sup>:

*"53. Bank acting as agent: a bank acting as agent in an SFT generally provides an indemnity or guarantee to only one of the two parties involved, and only for the difference between the values of the security or cash its customer has lent and the value of collateral the borrower has provided. In this situation, the bank is exposed to the counterparty of its customer for the difference in values rather than to the full exposure to the underlying security or cash of the transaction (as is the case where the bank is one of the principals in the transaction)."*

In centrally cleared derivatives markets the relationship is the same as it is here for SFTs, where banks act as agent for their clients. Clients access centrally cleared derivatives markets through a clearing member with direct access to the CCP. This clearing member is very commonly a bank, or an affiliate of a bank parent holding company, who then acts in an agent capacity for its clients' derivative positions. The bank clearing member, acting as an agent, effectively provides a guarantee to the derivatives CCP for the cost it would incur to close-out its clients' derivatives positions that is not covered by the initial margin collateral it has collected and segregated, and typically passed onto the derivatives CCP (i.e., the difference between the position value and the margin value). As mentioned earlier, this practice is extremely common in the centrally cleared derivatives markets. As of June 2018, CCP12 members required nearly \$390 billion US dollar equivalent of client initial margin for clients' derivatives positions<sup>4</sup>.

The market structure of centrally cleared derivatives markets, where banks act as agents for their customers, is cemented in the regulatory regimes of the respective jurisdictions in which CCP12 and EACH members operate. For example, for certain CCP12 members in the United States, this structure is cemented in the Commodity Futures Trading Commission's ("CFTC") and the Securities and Exchange Commission's ("SEC") regulatory regimes, and for CCP12 and EACH members in the European Union this structure is cemented in the European Market Infrastructure Regulation ("EMIR"). Importantly, each jurisdiction apply the CPMI-IOSCO *Principles for Financial Market Infrastructures*<sup>5</sup> ("PFMI"), which sets forth principle-based segregation standards regarding collateral and positions of clients of direct Clearing Members. In each jurisdiction, the implementation of Clearing Member and client account and collateral segregation requirements are tailored to the bankruptcy regimes and netting restrictions within those jurisdictions.

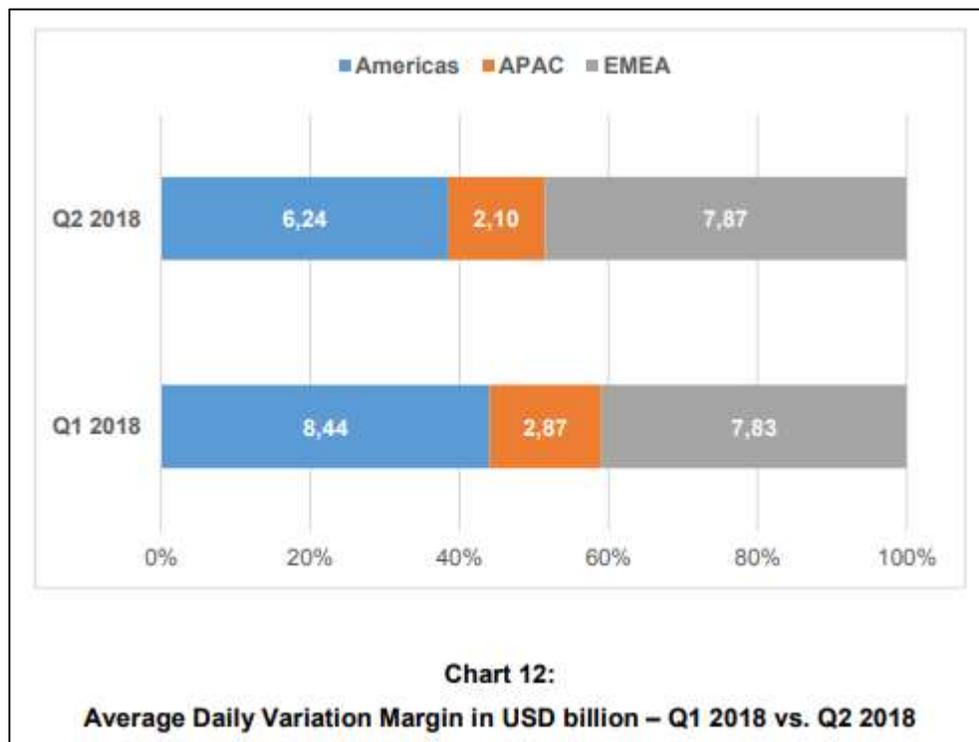
Out of simplicity, CCP12 and EACH members have a view that Option 3 proposed in the BCBS consultation is preferred because it is the simplest to implement given its use in the current risk-based capital requirements of Basel III, and it is most consistent with the centrally cleared market structure. Notably however, both Option 2 and Option 3 in the BCBS consultation would improve the Leverage Ratio regulatory capital treatment for banks providing client clearing services. In terms of quantification,

<sup>3</sup> <https://www.bis.org/bcbs/publ/d424.pdf>

<sup>4</sup> [http://ccp12.org/wp-content/uploads/2018/11/CCP12\\_PQD\\_Newsletter\\_Nov2018\\_Final.pdf](http://ccp12.org/wp-content/uploads/2018/11/CCP12_PQD_Newsletter_Nov2018_Final.pdf)

<sup>5</sup> <https://www.bis.org/cpmi/publ/d101.htm>

CCP12 members providing derivatives clearing services typically require over \$390 billion US dollar equivalent in client initial margin collateral from their clearing members, and routinely exchange variation margin \$16 billion US dollar equivalent<sup>6</sup> per day.



It is CCP12’s and EACH’s understanding that today banks providing derivatives client clearing services does not recognize initial margin and can only recognize a portion of this \$16 billion US dollar equivalent of variation margin, to the extent it is for client activity, as exposure reducing under the current Leverage Ratio design, otherwise referred to as Option 1 in the BCBS consultation. Option 2 in the BCBS consultation would allow for the recognition of the \$390B in client initial margin as exposure reducing, but not all of the \$16B in variation margin. Option 3 would allow for both recognition of the \$16B in variation margin applicable for client activity, as well as the \$390B in client initial margin as exposure reducing.

In the view of CCP12 and EACH members, Option 3 is consistent with the centrally cleared market structure, where CCPs and banks acting as clearing members would have control over both the variation margin and initial margin for clients to manage the close-out and default of a client. CCP12 and EACH members therefore believe that this is the preferred option proposed in the BCBS consultation.

<sup>6</sup> [http://ccp12.org/wp-content/uploads/2018/11/CCP12\\_PQD\\_Newsletter\\_Nov2018\\_Final.pdf](http://ccp12.org/wp-content/uploads/2018/11/CCP12_PQD_Newsletter_Nov2018_Final.pdf)

**Question 2: To what extent would the two potential revisions discussed in this consultative document 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?**

CCP12 and EACH believe the BCBS adoption of Option 3 would strengthen the banking system, and more broadly the financial system, by reducing the potential systemic risk impacts caused by the default of a clearing member to a CCP. For background, during the default of a clearing member to a CCP, a CCP will look to port the solvent non-defaulting clients of a defaulting clearing member to a new solvent clearing member with initial margin collateral. Under the current Basel III Leverage Ratio design, Option 1, the likelihood of successful porting is reduced because clearing members who would be willing to accept these new derivatives clients have to consider the Basel III Leverage Ratio capital requirements for accepting these clients and their positions, including the requirement that they cannot include in their leverage ratio calculation the exposure reducing nature of fully segregated client initial margin collateral they would receive directly from the CCP during this process.

It is important to distinguish that during this porting process, the client initial margin collateral is sent from the CCP to a new clearing member without any necessary approval from the defaulting clearing member. The lack of recognition of the role of initial margin under the leverage ratio completely ignores the fact that the accepting clearing member would receive, and in part base its decision to accept those ported clients on its receipt of client initial margin from the CCP to offset its exposures for the ported clients. In effect, one of the primary considerations for clearing members in bidding on a portfolio of client accounts is ignored by BCBS, Option 1, in the case of cleared derivatives.

Local markets regulation, for example EMIR, CFTC rules, etc., all make clear that collateral **held** by a CCP for the benefit of a clearing members' clients is kept segregated and under control of the CCP specifically so that it can be sent from one clearing member to another in order to maintain market operations and cover the risk of the clients' positions. This reduces systemic risk to the financial system by reducing the likelihood that a CCP is required to conduct the forced liquidation of non-defaulting client accounts while managing the default of a clearing member. BCBS' adoption of Option 3 would therefore completely align with the G20 Leaders' policy objectives of strengthening the resilience of the banking system by strengthening the centrally cleared markets to which the banking system is inextricably linked. However, the continued failure to properly account for the exposure reducing aspect of client initial margin (i.e., Option 1) increases the likelihood of forced liquidation during a market stress event, which in turn elevates overall systemic risk and undermines resilience by exacerbating volatility of an already stressed market.

In addition, BCBS's adoption of Option 3 under the consultation would allow greater access to central clearing. This was clearly demonstrated in the FSB DAT final report *Incentives to centrally clear over-the-counter (OTC) derivatives*. The report showed that banks which clear the majority of OTC derivatives client business were not constrained by the Leverage Ratio with respect to clearing their own activity, but at a client clearing level had seen a significant negative impact. Clearing members are forced to fully or partially pass these increased capital costs down to their clients or limit clients' access to central clearing, making central clearing more expensive and harder to access for both exchange-traded and OTC derivatives. This is unfortunately occurring as the number of clients and products subject to clearing mandates increase globally. Thus, adoption of Option 3 and proposed in the BCBS consultation would materially preserve and promote increased clearing capacity amongst clearing members and promote the central clearing of standardized derivative contracts.

**Question 3: What are the potential forward-looking behavioral dynamics of the client clearing industry that could occur as a result of possible changes to the leverage ratio treatment of client cleared derivatives?**

CCP12 and EACH members believe that the derivatives client clearing industry is more likely to experience an increase in demand for client clearing services in the near future as the OTC derivatives reforms, such as clearing mandates and margin requirements for non-centrally cleared derivatives, continue their phase-in process. If this consultation were to result in the BCBS recommendation for Option 3, this would positively contribute to limiting systemic risk and pave the way for the onboarding of more clients to access the benefits of central clearing services. The currently excessive capital costs for providing derivatives client clearing services have resulted in reduced access to client clearing services, and has the potential to influence the bidding and porting behavior of CCP12's and EACH's clearing members during the management of a clearing member default. Additionally a concentration of risk of client clearing services to fewer clearing members has partially resulted from the current leverage ratio model. Recognition of the derivatives client clearing market structure under the Leverage Ratio, through implementation of Option 3, would alleviate these unintended market dynamics which exist today.

CCP12 and EACH greatly appreciate the opportunity to comment on this consultative document. We would be interested to discuss these further and elaborate on any of the comments described in our response.

Sincerely,



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CEO of CCP12**



**Rafael Plata,  
Secretary General of EACH**