



November 18, 2014

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

Re: **Treatment of segregated margin in the calculation of centrally cleared derivatives exposures under the Basel III Leverage Ratio**

Dear Sirs and Madams:

This letter sets forth the reasons why the undersigned global trade associations and central counterparties (“Global Trade Associations and CCPs”) strongly believe that, in the context of a bank exposure created by a cleared derivatives transaction, the Basel III leverage ratio should recognize the exposure-reducing effect of margin that is *segregated*, because segregated margin cannot be used to increase the bank’s leverage. In particular, and as described in more detail below, if and when the Basel Committee on Banking Supervision (the “BCBS”) adopts the standardized approach for measuring counterparty credit risk exposures (“SA-CCR”) in the leverage ratio context as a replacement for the Current Exposure Method (“CEM”) for measuring such exposures—which we strongly support—it would be extremely important to recognize the exposure-reducing effect of segregated margin on cleared derivatives exposures.

The Global Trade Associations and CCPs consist of FIA Global, World Federation of Exchanges, CCP12, ICE, CME Group, LCH Clearnet Group, and Eurex Group. FIA Global, the alliance of FIA, FIA Europe and FIA Asia, is the primary global industry association for centrally cleared futures, options, and swaps. Its core members, many of which are banking organizations, are members of central counterparties (“CCPs”). FIA’s membership also consists of the major global futures exchanges, clearinghouses, trading platforms, and others that, together, make central clearing possible. The World Federation of Exchanges (“WFE”) is the global association representing the interests of 64 publicly regulated stock, futures, and options exchanges, as well as the CCPs that many of these exchanges operate. CCP12 is the global association of CCPs consisting of over 50 CCPs from all over the world.

I. Background

Earlier this year, the BCBS issued the *Basel III leverage ratio framework and disclosure requirements*, which sets forth the leverage ratio that will operate as a backstop to the risk-based capital standard (the “leverage ratio”).¹ While the leverage ratio is a final standard for reporting purposes, the BCBS has issued answers to “Frequently Asked Questions” or “FAQs” in order to address interpretive questions that have arisen during the implementation of the leverage ratio.² In addition, the BCBS has begun considering adjustments to the calibration and other aspects of the leverage ratio as the standard moves from a reporting-only requirement to a minimum capital requirement by the end of 2018. In this context, the Global Trade Associations and CCPs submit this letter regarding the appropriate treatment of segregated margin for exposures arising out of centrally cleared derivatives transactions, one of the key issues for our members.

We recognize that the leverage ratio has been adopted as a backstop to the risk-based capital ratio. It is critical, however, that the denominator of the leverage ratio—the “total leverage exposure”—accurately capture the actual off-balance sheet exposures that a banking organization has to its counterparties, including exposures arising out of centrally cleared derivatives transactions. In this regard, the Global Trade Associations and CCPs are deeply concerned about the failure of the leverage ratio to recognize the exposure-reducing effect of segregated margin in the limited context of centrally cleared derivatives transactions (whether executed over-the-counter or through an exchange).³ Unlike margin posted in many uncleared derivatives transactions, margin that is segregated—as is very often the case for cleared derivatives transactions—may *not* be leveraged by a bank.⁴ As a result, such segregated margin is solely exposure-reducing with respect to a bank’s cleared derivatives exposure, and

¹ Basel Committee on Banking Supervision, *Basel III leverage ratio framework and disclosure requirements* (Jan. 12, 2014), available at <http://www.bis.org/press/p140112a.htm>.

² Basel Committee on Banking Supervision, *Frequently asked questions on the Basel III leverage ratio framework* (Oct. 7, 2014), available at <http://www.bis.org/publ/bcbs293.htm>.

³ As used in this letter, “segregated margin” refers to margin—other than variation margin—that is provided to a clearing member but cannot be used by that member to leverage itself due to national laws, regulatory/client money rules or clearinghouse requirements that prevent clearing members from using posted collateral for purposes other than collateralising client exposure, including, for example, rules issued by the Commodity Futures Trading Commission, e.g., 17 C.F.R. §§ 1.20-1.30 (futures) and 17 C.F.R. §§ 22.2- 22.7 (cleared swaps), and rules issued under the UK Client Asset Sourcebook (“CASS”) regime, e.g., CASS 7.3.1R and CASS 7.4.1R. Segregated margin usually consists of initial margin.

⁴ Segregated margin typically can be invested only in bank deposits or very conservative, highly liquid investments; as a result, it cannot be used by the clearing bank to truly leverage itself through loans or high risk investments. See, e.g., 17 C.F.R. § 1.25; see also *infra* note 12.

accordingly, we strongly believe that the leverage ratio's total leverage exposure ought to recognize that reduction. Furthermore, as described in more detail below, a failure to recognize the exposure-reducing effect of segregated margin will have materially adverse consequences on cleared derivatives markets, end users, and market participants.

Accordingly, Part II of this letter summarizes the leverage ratio's failure to recognize the exposure-reducing effect of segregated margin in the calculation of derivatives exposures, including the potentially compounding effect of the leverage ratio's treatment of such margin received in the form of cash; it also explains why the stated policy rationale for this lack of recognition does not apply in the context of segregated margin for centrally cleared derivatives exposures. Part III describes the likely adverse effects of the failure to recognize the exposure-reducing effect of segregated margin on cleared derivatives markets and market participants, as well as the inconsistency of this failure with the global policy to promote centralized clearing agreed to at the Pittsburgh G20 Summit in 2009. Finally, Part IV describes several alternatives that we believe the BCBS should consider in order to recognize the exposure-reducing effect of segregated margin on cleared derivatives exposures in the leverage ratio, especially in the context of its consideration of the replacement of CEM with SA-CCR for purposes of calculating derivatives exposures.

II. The Leverage Ratio's Failure to Recognize the Exposure-Reducing Effect of Segregated Margin in the Calculation of Cleared Derivatives Exposures

The leverage ratio generally adopted the CEM to capture off-balance sheet derivatives exposures, including centrally cleared derivatives exposures, in its measure of total leverage exposure.⁵ In the risk-based capital context, the CEM is used to calculate an institution's potential future exposure ("PFE") with respect to derivatives exposures, and the PFE calculation recognizes the exposure-reducing effect of margin.⁶ While the leverage ratio

⁵ See leverage ratio, ¶ 19 n.5.

⁶ Indeed, in the risk-based capital context, the BCBS has repeatedly recognized the exposure-reducing effect of margin. See, e.g., *Capitalisation of bank exposures to central counterparties* (Nov. 2011), available at <http://www.bis.org/publ/bcbs206.htm>; *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* (Feb. 2013), available at <http://www.bis.org/publ/bcbs241.htm>; *Capital treatment of bank exposures to central counterparties* (June 2013), available at <http://www.bis.org/publ/bcbs253.htm>; *The non-internal model method for capitalising counterparty credit risk exposures* (June 2013), available at <http://www.bis.org/publ/bcbs254.htm>; *Margin requirements for non-centrally cleared derivatives* (Sept. 2013), available at <http://www.bis.org/publ/bcbs261.htm>; *The standardised approach for measuring counterparty credit risk exposures* (Mar. 2014; rev. Apr. 2014), available at <http://www.bis.org/publ/bcbs279.htm>; *Capital requirements for bank exposures to central counterparties* (Apr. 2014), available at <http://www.bis.org/publ/bcbs282.htm>; and *Supervisory framework for measuring and controlling large exposures* (Apr. 2014), available at <http://www.bis.org/publ/bcbs283.htm>.

generally incorporated a CEM-based methodology to capture derivatives exposures, it differs from risk-based CEM in one critical respect: the leverage ratio's CEM approach does not permit margin to reduce derivative exposures—except for cash variation margin in certain circumstances⁷—with no distinction made between (1) derivatives exposures where the margin is not segregated, and (2) those cleared derivatives exposures where the margin is segregated: “As a general rule, collateral received may not be netted against derivative exposures whether or not netting is permitted under the bank's operative accounting or risk-based framework.”⁸

In articulating this sweeping “general rule,” the leverage ratio expressly acknowledges that margin collateral “reduces counterparty exposure,” but that it can also have a countervailing effect: “it can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself.”⁹ As a result, the leverage ratio states, “[c]ollateral received in connection with derivative contracts does not necessarily reduce the leverage in a bank's derivatives position, which is generally the case if the settlement exposure arising from the underlying derivative contract is not reduced.”¹⁰ Thus, the ability of a bank to leverage the margin collateral it receives from a derivatives counterparty is the *sole policy rationale* for concluding that “a bank must not reduce [a derivative] exposure amount by any collateral received from the counterparty.”¹¹

The Global Trade Associations and CCPs understand this policy rationale with respect to margin that is neither segregated for the client nor cash variation margin; such non-segregated margin can be re-hypothecated and leveraged for the benefit of the bank, as is currently the case with respect to initial margin posted in most uncleared derivatives transactions. But in the central clearing context, that rationale simply does not apply to margin that is segregated, because segregation by definition prohibits the bank from leveraging such collateral for its own benefit. When it is segregated for the client in this manner, margin received is solely exposure-reducing; it is not “at the disposal of the bank,” and the bank *cannot* “use the collateral to leverage itself.” As a result, where margin is segregated, the leverage ratio's policy rationale for not recognizing its otherwise exposure-reducing effect is inapplicable.

In practice, the margin posted in centrally cleared derivatives transactions is frequently segregated. For example, in the United States, rules established by the Commodity

⁷ Leverage ratio, ¶¶ 25-26.

⁸ Leverage ratio, ¶¶ 22-24.

⁹ Leverage ratio, ¶ 22.

¹⁰ Leverage ratio, ¶ 23.

¹¹ *Id.*

Futures Trading Commission require such segregation for all cleared derivatives transactions.¹² Similarly, in the United Kingdom, such segregation occurs with respect to clients that are provided money protection under the Client Asset Sourcebook (“CASS”).¹³ Indeed, whenever margin is “on-posted” to a derivatives clearinghouse or deposited with a third party, it is no longer in the control of the clearing member bank and cannot be used by that bank to leverage its activities. Accordingly, the Global Trade Associations and CCPs strongly believe that segregated margin posted in cleared derivatives transactions, which cannot be leveraged by the clearing member bank, ought to be recognized as exposure-reducing under the leverage ratio.

Moreover, the leverage ratio’s inappropriate treatment of segregated margin in cleared transactions is compounded where such margin is posted in the form of cash, rather than securities, as is often the case. The accounting rules of some jurisdictions require such segregated cash margin to be treated as an on-balance sheet asset of the receiving bank, and as such, the segregated cash is included as a separate leverage exposure in the denominator of the bank’s leverage ratio.¹⁴ In these circumstances, the bank is subject to a *double* leverage ratio penalty: (1) the segregated cash margin received may not be used to reduce a cleared derivatives exposure in the denominator of the bank’s leverage ratio, and (2) because such segregated cash margin is treated as an on-balance sheet asset, it must be separately added as an exposure to that denominator as well.

¹² 17 C.F.R. §§ 1.20-1.30 (futures); 17 C.F.R. §§ 22.2- 22.7 (cleared swaps). Under these rules, a bank must separately account for, and segregate as belonging to the client, all money, securities and property it receives from a client as margin. In addition, the bank may not use such segregated margin to support its own operations or re-invest the collateral except for investments in a narrow range of very low risk and highly liquid assets, such as U.S. government and municipal securities, managed “with the objectives of preserving principal and maintaining liquidity.” 17 C.F.R. § 1.25.

¹³ CASS 7.3.1R and CASS 7.4.1R.

¹⁴ *See, e.g.*, 79 Fed. Reg. 57,725, 57,735 (col. 2-3), 57,742 (col. 1) (Sept. 26, 2014). Conversely, segregated margin received by a bank in the form of securities, rather than cash, is not treated as an asset on the balance sheet of the bank for accounting purposes, and as a result, is also not included as a separate exposure in the leverage ratio. *See, e.g.*, 79 Fed. Reg. at 57,742 (col. 1). This differential leverage ratio treatment of cash margin and securities margin creates a perverse incentive for a bank to prefer the receipt of margin (other than variation margin) in the arguably riskier form of securities rather than cash. And where margin is provided in the form of cash, a bank would have another perverse incentive to take less margin than might be optimal for risk management purposes, since any cash margin received would increase the bank’s total exposure measure under the leverage ratio.

III. Consequences of Excluding Margin in Measuring Derivative Exposures for Cleared Transactions

If not clarified or amended, the failure of the leverage ratio to recognize the exposure-reducing effect of segregated margin—compounded in the case of such margin received as cash—will likely have seriously negative effects on cleared derivatives markets and market participants, including end users. The margin practices and requirements of centrally cleared derivatives markets make banks' participation in the derivatives clearing business a lower risk activity, with appropriate risk-based capital requirements calibrated in the recently finalized standard for bank exposures to central counterparties.¹⁵ In this context, the failure to recognize the exposure-reducing effect of segregated margin for leverage ratio purposes will substantially and unnecessarily increase the amount of required capital that will need to be allocated to this business.

Such a significant increase in required capital will also significantly increase costs for end users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers. Further, banks may be less likely to take on new clients for derivatives clearing. As a result, market participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks.

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. That is, in times of market stress, when banks' capital may decline to levels that make the leverage ratio a truly binding limit, the ability of such banks to purchase portfolios of cleared derivatives from other banks—including distressed banks—will be severely constrained. Moreover, as the levels of margin required by CCPs increase in times of stress, leverage ratio capital costs will correspondingly increase, aggravating the constraint on portfolio purchases. Such a constraint on providing liquidity to stressed markets would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.

Significantly increased capital costs will also likely result in market exit by some derivatives clearing members that will find the business no longer economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end user access to the risk mitigation benefits of central clearing.

¹⁵ Basel Committee on Banking Supervision, *Capital requirements for bank exposures to central counterparties* (Apr. 10, 2014), available at <http://www.bis.org/publ/bcbs282.htm>.

The consequences outlined above are fundamentally inconsistent with global policies designed to enhance the appropriate use of centrally cleared derivatives. The Pittsburgh G20 commitments of 2009 established a clear policy that mandatory clearing of certain derivatives is essential to improving risk management and promoting financial stability. The Dodd Frank Act (“DFA”) in the United States and European Market Infrastructure Regulation (“EMIR”) in Europe translated this policy into binding regulatory requirements. Unfortunately, if not amended, the leverage ratio will be plainly at odds with these commitments and requirements:

- DFA and EMIR are built on the assumption that there will be an adequate number of clearing members that are able to, and remain willing to, provide access to clearing houses for their direct and indirect clients, and that as a result, clearing members will significantly increase the number of clients for which they provide clearing services;
- The current treatment of segregated margin in the leverage ratio may discourage clearing members from working with clients that create a higher balance sheet and leverage ratio impact; clients that typically enter into long-dated, very directional derivatives transactions (such as pension funds and insurance companies, for example), fall into this category.

IV. Possible Ways to Recognize the Exposure-Reducing Effect of Segregated Margin on Cleared Derivatives Exposures

If the BCBS were to decide that, in the context of cleared derivatives transactions, exposures should be reduced by segregated margin, there would be at least three ways to achieve this result.

First, the BCBS could issue an FAQ document interpreting the current leverage ratio text to permit an exception to the “general rule” that prohibits the recognition of collateral as exposure-reducing in the context of derivatives transactions generally. As discussed above, the expressed policy rationale for this general prohibition is concern about collateral increasing the economic resources at the disposal of the bank, and thus, the ability of the bank to use collateral to increase leverage. Again, this policy concern is not present in the context of segregated margin provided in the context of cleared derivatives transactions. Where a clearing member bank is simply unable to leverage margin because it is segregated, the sole effect of the margin is to reduce exposure, not increase leverage. In addition, recognition of the exposure-reducing effect of segregated margin in the clearing context would avoid the negative consequences to the cleared derivatives market described above, which would be fully consistent with clear BCBS policies designed to foster centralized clearing of derivatives. Accordingly, an FAQ could clarify that, while the leverage ratio generally continues to prohibit the recognition of collateral reductions in derivatives exposures generally, that prohibition would not apply in the limited context of cleared derivatives transactions where the collateral takes the form of margin that is segregated so that it cannot be leveraged. In addition, the FAQ could also clarify that, for

the same reasons, segregated margin received in the form of cash should not be counted as an exposure in the denominator of a bank's leverage ratio, even if treated as an on-balance sheet asset under the particular accounting regime applicable to that bank.

Second, the BCBS could amend the text of the leverage ratio to expressly recognize the exposure-reducing effect of segregated margin in the context of cleared derivatives exposures. While the amended text of the leverage ratio was finalized just last January, the Committee has made clear that it will soon be revisiting that text in the context of considering a recalibration of the leverage ratio, as well as in the context of finalizing the leverage ratio as a minimum capital requirement. While the Global Trade Associations and CCPs do not believe that it is necessary to amend the text to achieve recognition for segregated margin, or the exclusion from total leverage exposure of segregated margin received in the form of cash, such an amendment would be appropriate if the BCBS decided not to adopt the FAQ interpretive approach.

Third, we note that, even as the BCBS adopted the modified version of the CEM in the final leverage ratio in January of 2014, it stated that it was considering alternatives to replace CEM in the risk-based context, and that, if an alternative calculation methodology were adopted in that context, the Committee would then consider whether a similar alternative approach would be appropriate in the leverage ratio context.¹⁶ In March and April of 2014, the BCBS did indeed adopt an alternative calculation methodology to replace CEM in the risk-based context: SA-CCR. SA-CCR is a considerably improved alternative to CEM as it recognizes the benefit of collateral and netting agreements and appropriately differentiates between margined and unmargined trades; in the risk-based context, SA-CCR also expressly recognizes the exposure-reducing effect of margin. The Global Trade Associations and CCPs understand that the BCBS is now considering whether SA-CCR should replace the CEM approach used to calculate derivatives exposures in the leverage ratio. We strongly believe that replacing CEM with SA-CCR in the leverage ratio context would be just as much an improvement as it is in the risk-based context. In addition, we believe that any process to modify the leverage ratio to incorporate SA-CCR would also present an appropriate opportunity—and perhaps the best and most logical opportunity—for the extremely important recognition of the exposure-reducing effect of segregated margin on cleared derivatives exposures.

Finally, we strongly urge the BCBS to undertake a Quantitative Impact Study on the treatment of cleared derivatives transactions under the leverage ratio.¹⁷ In this context, we

¹⁶ Leverage ratio, ¶ 19 n.5.

¹⁷ The OTC Derivatives Assessment Team (OTC DAT), comprised of members of the Financial Stability Board and the BCBS, recently concluded that “quantitative analysis indicate that clearing member banks (ie those institutions that clear directly with CCPs) have incentives to clear centrally.” OTC DAT, *Regulatory reform of over-the-counter derivatives: an assessment of incentives to clear centrally*, 1 (Oct. 2014), available at (continued...)

would further urge such a study to gather data on margin, including data on the extent to which cleared derivatives exposures are collateralized by margin that is segregated and cannot be leveraged, as described in this letter.

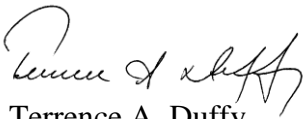
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Thank you for considering the issues raised in this letter. If you have any questions or need additional information, please contact Jacqueline Mesa, Executive Director, FIA Global, at 1 202-772-3040 or jmesa@fia.org.

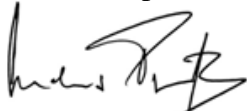
Yours faithfully,



Siddharta Roy
Chairman
CCP12



Terrence A. Duffy
Executive Chairman and President
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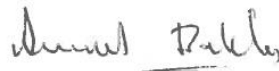
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