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FIA feedback on the European Commission's Proposal for alignment of EU rules on capital requirements to international standards (prudential requirements and market discipline)

Proposed segregation condition for recognition of initial margin offset when calculating leverage ratio exposure value

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers.

FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

FIA welcomes the opportunity to provide feedback on the proposed changes to the EU's Capital Requirements Regulation (CRR). Our response focuses on a narrow issue, which may have material negative ramifications for the institutions subject to CRR that provide derivatives client clearing services, namely the proposed new segregation condition for recognition of initial margin (IM) offset when calculating leverage ratio exposure value. We have set out our comments on and solution to the proposed changes to CRR Article 429c in the letter below.

1. FIA believes that segregation should not be a condition to recognition of margin

While we note that the final Basel Committee rules on the leverage ratio treatment of client cleared derivatives envisage a level of segregation of initial margin received by the bank clearing service provider, *as defined in the relevant jurisdiction*, we would like to reiterate the arguments that we made in response to the BCBS Consultative Document on the leverage ratio's treatment of client cleared derivatives in January 2019 (Response), which explain why we believe that segregation should not be a condition for recognition of margin. The same arguments continue to be relevant also

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in the context of the European Commission's proposed changes to CRR Article 429c, specifically the proposed new paragraph 4a.

In the Response, we supported the adoption of a policy solution without the imposition of segregation criteria for margin that would offset exposure under the leverage ratio. As a threshold matter, we noted that segregation primarily is designed to protect clients from banks' default, rather than the reverse. While there are good reasons for jurisdictions to implement protections that minimize clients' exposures to banks, the leverage ratio is designed to capture banks' exposures, including to their clients.

In the past, the Basel Committee has expressed some concern that a bank can use margin to leverage itself.[1] However, the vast majority of initial margin in a cleared derivative transaction is held by the CCP and is unavailable for reinvestment by the bank. Additionally, with respect to the limited amount of initial margin held by the bank, the on-balance sheet component of the leverage ratio otherwise accounts for the possibility of reinvestment:

- ***Reinvestment Rights Create On-Balance Sheet Exposure***. In certain limited circumstances, applicable law permits a bank acting as clearing member to reinvest client margin in highly liquid, ultrasafe assets such as the highest-rated sovereign debt. The bank will often remit a portion of the income from reinvestment of margin to the client that provided the margin, which reduces the client's opportunity cost of clearing and makes clearing more affordable. Importantly, when the bank can reinvest cash margin, and when it does reinvest non-cash margin, the margin is counted as an on-balance sheet exposure of the bank under the leverage ratio denominator. Such treatment effectively reverses any offset that the Basel Committee may adopt to recognize the exposure-reducing effect of initial margin.

- ***Relinquishing Reinvestment Rights Can Remove On-Balance Sheet Exposure***. Some banks have been able to move cash initial margin off their balance sheets under applicable accounting rules by, among other things, passing back to the client the interest paid on client balances held at a CCP, broker, or third party bank. The client incurs all principal risk. In these circumstances, the clearing member bank is not using the margin to "leverage itself" in any sense.

Accordingly, to the extent that the European Commission remains concerned about the possibility of a bank reinvesting initial margin, despite the extremely limited degree of reinvestment that is permitted by law, the leverage ratio already accounts for this possibility by counting reinvestment-related exposures. It is not necessary to impose segregation criteria to address this concern.
In addition, the risk-based version of SA-CCR does not include segregation criteria. The Basel Committee or the European Commission have not expressed any reason why the risk-based and leverage capital rules should differ in this respect. It would be far simpler for the policymakers, the

[1] *See, e.g.*, Basel Committee on Banking Supervision, Basel III: Finalising Post-Crisis Reforms, at p. 146 (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424.htm.

regulators and banks to adopt SA-CCR's treatment of margin than to incorporate additional complex requirements. Such an approach of adopting SA-CCR's treatment of margin in the leverage ratio would also fulfill the Basel Committee's stated goal to "strike an appropriate balance between the complementary goals of risk sensitivity, simplicity and comparability."[2]

Finally, we noted that the Basel Committee had not imposed segregation criteria in connection with the offset it adopted in paragraph 53 of the leverage ratio for collateral a bank receives in a securities financing transaction. In keeping with this precedent, we argued that the Basel Committee should not have imposed segregation criteria in connection with revisions to the leverage ratio's treatment of derivatives clearing to recognize initial margin, and the same arguments apply also in the context of the proposed European Commission's requirements.

2. If the European Commission decides to keep the segregation criterion as a condition for recognition of margin, we believe that the condition should be clarified to mean compliance with EMIR segregation requirements

FIA members are concerned about the proposed limb (c) in new paragraph 4a of Article 429c of CRR as it is unclear and potentially problematic. More specifically:

- It is unclear what level 'segregation' needs to apply at. Is it at a clearing member or a CCP level? There is also uncertainty as to whether ISAs are sufficient to fully meet this criterion. because even with an ISA there is transit risk/a period in time where segregation from the clearing member is not achieved. Would, for example, a gross or net omnibus structure meet this criterion?
- It is unclear whether the segregation condition, as currently drafted, requires banks to take collateral from their clients by way of security interest only, or whether title transfer collateral arrangements are also acceptable. Our strong view is that it should not matter how collateral is provided to the clearing member.
- It is unclear as to whether segregation is required to cover the time period between the clearing member receiving collateral and onward posting it to the CCP.
- It is unclear what limb (c) requires practically. For example, in the case of client delivering X to the clearing member and the clearing member transforming that asset to deliver Y (Y having the same value but a different form to X) to the CCP, is it sufficient for the value of X to be at the CCP? Or does X itself need to be segregated, as this would seem to prevent collateral transformation. In other words, it is unclear whether the proposed segregation condition requires value segregation or asset segregation.
- The intention behind this additional limb is unclear given clearing segregation model relates to client protections and so having this as a condition for clearing member risk reduction seems

[2] *See* Basel Committee on Banking Supervision, Discussion Paper: The Regulatory Framework: Balancing Risk Sensitivity, Simplicity, and Comparability (July 2013), *available at* https://www.bis.org/publ/bcbs258.htm.

unnecessary. It would create undue cost in the clearing ecosystem without reducing the risk profile.

- Where clearing members call margin from clients on a gross basis and post to the CCP on a net basis, some collateral will not reach the CCP but it will be held/ deposited elsewhere in accordance with local law and regulations. Firms already incur leverage on where that sits so this further condition would seem to prevent/penalise that which is already accounted for in reporting (double counting).

On the basis of the above, and if the European Commission considers that it has to impose a segregation condition to allow banks to include the amount of IM received by the bank from its clearing clients in the values of collateral and NICA despite the arguments against it set out in Section 1 above, **we propose that the segregation condition be clarified to mean that banks automatically meet it by complying with the segregation requirements set out in EMIR Article 39**. This would ensure a purposeful and practical implementation of this requirement. It would also allow EU banks to remain competitive globally and continue to provide derivatives client clearing services to EU and other clients.