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September 20, 2013

Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland  
[baselcommittee@bis.org](mailto:baselcommittee@bis.org)

Re: **Consultative Document on the Revised Basel III Leverage Ratio Framework**

Dear Sirs and Madams:

The Futures Industry Association (“FIA”) appreciates this opportunity to comment on the Consultative Document, *Revised Basel III leverage ratio framework and disclosure requirements* (“Proposed Framework”), issued by the Basel Committee on Banking Supervision (“the Committee”).<sup>1</sup> The FIA is the primary industry association for centrally cleared futures, options, and swaps. Its core members are futures commission merchants (“FCMs”), many of which are banking organizations that are members of central counterparties (“CCPs”). The FIA’s membership also includes the major global futures exchanges, clearinghouses, trading platforms, technology vendors, and legal services firms that make central clearing possible.

The FIA understands that the Proposed Framework is intended to apply to all client cleared derivatives (futures, listed options, and swaps). The FIA also understands the Committee’s concern that bank exposures to central counterparties must be adequately capitalized. At the same time, the FIA supports the Committee’s goal to “preserv[e] incentives for central clearing, [and] promot[e] robust risk management by banks and CCPs” “in support of the G20 mandate to clear centrally all standardised over the counter derivatives.”<sup>2</sup> In this context, the remainder of this letter sets forth the FIA’s comments on the Proposed Framework.

Part I summarizes the Proposed Framework’s penalizing approach to central clearing given the proposed higher leverage capital requirements for client cleared

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<sup>1</sup> Basel Committee on Banking Supervision, *Consultative Document: Revised Basel III leverage ratio framework and disclosure requirements* (June 2013).

<sup>2</sup> Basel Committee on Banking Supervision, *Consultative Document: Capital treatment of bank exposures to central counterparties* ¶ 3 (June 2013 rev. July 2013).

derivatives—futures, listed options, and swaps—than for bilateral, uncleared derivatives. Part II provides an overview of central clearing and client clearing. Part III recommends that client clearing of derivatives should be excluded from the Exposure Measure. Part IV requests, in the alternative, that the CCP leg of a client cleared derivative should be excluded from the Exposure Measure, and that the client leg of such a derivative should be measured using a methodology that captures the margin and netting benefits of central clearing.

## **I. Introduction and Overview**

The Proposed Framework expands upon the Basel III leverage ratio first adopted in 2010 by enlarging the denominator of the leverage ratio (“the Exposure Measure”), raising the prospect of narrowing the numerator of the leverage ratio, and potentially recalibrating the leverage ratio itself. All of these factors may make the leverage ratio the binding or near binding ratio, thus affecting banks’ behavior and participation in product markets. The Proposed Framework would apply the current exposure method (“CEM”), which is the sum of the replacement cost and potential future exposure (“PFE”), to measure derivative exposures.

The proposed treatment of derivatives is intended to capture three main concerns: first, “an exposure arising from the underlying of the contract”;<sup>3</sup> second, “a counterparty credit risk exposure”;<sup>4</sup> and third, collateral re-hypothecation and re-use.<sup>5</sup> The imposition of leverage capital charges on futures, options, and swaps transactions cleared through a CCP in an intermediation capacity<sup>6</sup> on behalf of a client (“client cleared derivatives”) is inappropriate because features and regulations specific to client clearing already address each of the Committee’s three concerns.

With regard to the first concern of the “exposure arising from the underlying of the contract”—which we understand to mean market risk—we note that a clearing member is not exposed to the market risk of the client’s derivative position in its capacity as an intermediary. The client is engaged in a trade with the CCP, the derivative is the client’s position, and the client is exposed to changes in the underlying position.

With regard to the second concern on “counterparty credit risk exposure,” a clearing member bank’s exposure to its client is substantially reduced through initial margin and variation margin. To the extent the clearing member is exposed to close-out risk upon its client’s default, that risk is reduced through variation margin that is marked-to-market on a daily or twice-daily basis; the margin moves with the underlier to reduce exposure to changes in the underlying position.

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<sup>3</sup> Proposed Framework, at ¶ 22.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at ¶ 26.

<sup>6</sup> A clearing member bank acts in an intermediary capacity if it does not guarantee the performance of the CCP to its clients.

With regard to the third concern of re-hypothecation and re-use, the client's margin is segregated and subject to restrictions that substantially limit—and even prohibit—re-hypothecation and re-use under laws that are specifically tailored to client clearing.

To the extent the leverage ratio applies to client cleared derivatives, the measurement methodologies used would far overstate actual exposures arising from these transactions by failing to acknowledge the substantial exposure-reducing effects of initial and variation margin. These penalizing effects should not be underestimated. This overstatement would be especially punitive in the case of cash collateral: such cash would not be recognized as offsetting the derivatives exposure it collateralizes, yet it would be included as a separate exposure on the bank's balance sheet—a potential double count.<sup>7</sup> Further, the Proposed Framework would require at least double the leverage capital charges on client cleared derivatives as compared to bilateral, uncleared derivatives.

If the leverage ratio becomes the binding capital requirement (rather than the supplemental, backstop requirement), the resulting leverage capital charges will make client clearing economically unviable for clearing member banks and prohibitively expensive for end-users. These high capital charges will be passed down to customers in the form of fees. Where derivatives must be cleared through CCPs (such as swaps in the United States), end-users may elect not to hedge with these derivatives at all rather than pay the high fees associated with client clearing. Where derivatives are not mandated to be cleared through CCPs, end-users may elect to engage in bilateral, uncleared trades. All of these consequences would make the market less, rather than more, safe.

Thus, any final version of the Exposure Measure should not include client cleared derivatives. Should the Committee choose not to adopt this recommendation, the FIA urges the Committee, as described below, to (1) exclude the CCP leg of a client cleared derivative, and (2) measure the exposure of any leg of a client cleared derivative that is included in the Exposure Measure using a methodology that recognizes margin and netting. The FIA believes that the non-internal models approach (“NIMM”) could be an appropriate measurement methodology to achieve this result, so long as any final version of the NIMM appropriately reflects the industry's recommendations regarding this new exposure measurement method.<sup>8</sup>

## **II. Background on Client Clearing**

As the Committee and national regulators have recognized, clearing and trade execution requirements for derivatives are among the cornerstones of the new regulatory framework for derivatives, including client cleared derivatives. Clearing for such transactions

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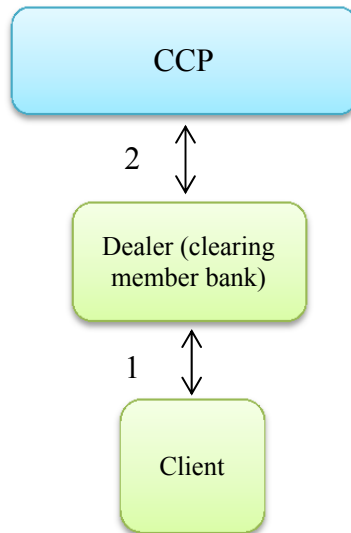
<sup>7</sup> It is our understanding that this treatment would not apply where the variation margin represents full and final settlement of the prior day's market move, rather than representing collateral.

<sup>8</sup> See Basel Committee on Banking Supervision, *The non-internal model method for capitalising counterparty credit risk exposures* (June 2013, rev. 25 July 2013) [hereinafter “NIMM Consultative Document”]. The industry is still evaluating the effect of NIMM on derivatives. The FIA's member organizations expect to file letters responding to the Committee's NIMM Consultative Document.

reduces risk, increases transparency, and promotes market integrity within the financial system through a range of important structural features, including:

- Clearing members of CCPs that clear client derivatives in an intermediary capacity (that is, those who do not guarantee the performance of the CCP to their clients) have no market risk with respect to the client's derivative position.
- CCPs demand initial margin from their clearing members on both sides of the derivative and require their clearing members to demand the same from their clients in the form of cash or low risk, highly liquid securities. These requirements reduce counterparty exposure of clearing members to their clients, mitigate close-out risk in the event of a client's non-performance, and reduce counterparty exposure of the CCP to its clearing members.
- In addition to initial margin, CCPs require their clearing members, and clearing members in turn require their clients, to post daily maintenance or variation margin in the form of cash. Variation margin is determined based on the mark-to-market value of the cleared portfolio. If the client defaults, the liquid market for centrally cleared derivatives permits the clearing member of the CCP promptly to liquidate the client's position, typically with little impact to the clearing member or the CCP.
- Clearing members and CCPs are required to hold customer margin at all times in segregation, only with permitted depositories, only in specifically denominated accounts, and subject to the segregated custodian's undertaking that no lien will be asserted against the margin by the custodian.
- Clearing members and CCPs are subject to significant restrictions on their use of customer margin, which effectively prohibit the use of such margin except for the purpose of meeting customer obligations at the CCP and for investment in certain highly liquid assets.
- CCPs also maintain default funds to cover any residual losses incurred as a result of the default of a clearing member (that is, losses that are not covered by margin). Clearing members must contribute cash or other low risk, highly liquid assets to the default fund. The CCP itself also must commit some of its own equity capital to the default fund. The default fund provides a further safeguard to cover losses arising from a client default large enough to trigger the default of a clearing member.

In addition, it is important to understand the structural differences between client clearing and a bilateral, uncleared trade. In a bilateral, uncleared trade, one party has a direct exposure to a counterparty. Client clearing, by contrast, is an intermediary function that can essentially be broken down into two legs. The first leg is the "client leg," where the clearing member bank intermediates a trade between the client and the CCP. The second leg is the "CCP leg," where the clearing member bank intermediates a trade between the CCP and the client.



As discussed further in the following sections, we believe that the Proposed Framework fails to account for these exposure-reducing safeguards in client cleared derivatives.

### **III. Exclude Client Cleared Derivatives**

Although the FIA appreciates the need to capture banks' exposures to derivatives transactions, we also believe it is critical that client clearing services not be subject to punitive capital requirements, which would directly contravene the intent of the clearing mandate currently in force or being implemented in Basel-member jurisdictions and threaten to disrupt mature markets in futures and listed options. To the extent the Proposed Framework applies to these client cleared derivatives, the Exposure Measure would significantly overstate a bank's actual exposure to such transactions, for the reasons described below.

First, the Proposed Framework mis-measures a clearing member's exposure to client cleared derivatives where the clearing member acts in an intermediary capacity without assuming exposure to the underlying contract (that is, without assuming market risk). In a client cleared derivative, the client is engaged in a trade with the CCP, with the client's money, and the client is exposed to changes in the underlying position.

Second, the client clearing member's exposure to the client is substantially reduced with initial margin and variation margin. The client must post initial margin in the form of cash or highly liquid securities to engage in the derivative trade with the CCP, regardless of whether the client is "in the money" or "out of the money." This initial margin reduces the clearing member bank's exposure to client default. The client also must post variation margin on a daily basis, as discussed above, which further reduces the bank's exposure to default. Variation margin moves with the underlier, is marked-to-market and collected daily, and is paid in riskless cash. Variation margin thus substantially reduces the clearing member bank's exposure to changes in the client's underlying position.

The CEM, which was designed for bilateral derivatives, fails to account for these exposure-reducing effects of initial and variation margin.<sup>9</sup> As regulators and the industry have long recognized, the CEM fails to differentiate between margined and unmargined transactions, fails to appropriately capture netting benefits, and fails to sufficiently capture the volatility of derivatives exposures.<sup>10</sup>

Third, the proposed requirements not to count collateral received (from clients) and to gross-up collateral provided (to the CCP) are especially inappropriate in the context of cleared derivatives. This lack of recognition of margin as exposure-reducing appears to be driven by concerns about re-hypothecation and re-use.<sup>11</sup> This is not a reasonable concern in the client clearing context because both clearing members and CCPs are subject to strict client protection laws and regulations that require a clearing member bank to segregate client funds in separate accounts to restrict—and even prohibit—re-hypothecation and re-use.<sup>12</sup> In the limited instances where a clearing member is permitted to re-invest the client’s margin in certain highly liquid assets, that re-investment would be included as an additional exposure in the Exposure Measure and would therefore be subject to additional leverage capital requirements. Thus, the Committee’s concerns about re-hypothecation and re-use have already been addressed through more targeted regulatory measures.

Fourth, the Proposed Framework would especially penalize cash collateral. CCPs require their clearing members, who in turn require their clients, to post initial margin in the form of cash or highly liquid securities and daily variation margin in the form of cash. Unlike other types of collateral, cash collateral is added to the collateral receiver’s balance sheet. To the extent that on balance sheet cash collateral is included in the Exposure Measure, the Proposed Framework could double count the value of this collateral<sup>13</sup> by requiring the clearing member bank to include (1) the full value of the derivatives exposure without an offset for cash collateral received,<sup>14</sup> and (2) the full value of the cash collateral received.<sup>15</sup> This double count magnifies the Exposure Measure beyond actual economic exposure levels.

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<sup>9</sup> We feel that the replacement cost, defined as gross mark-to-market, does not accurately reflect the exposure of a clearing member to a client cleared derivative. Variation margin is paid/received daily and represents the current mark-to-market exposure on the client derivative. We thus recommend that the variation margin received be used to reduce the replacement cost, as the current exposure to the client’s derivative is extinguished.

<sup>10</sup> See, e.g., NIMM Consultative Document, at ¶ 6.

<sup>11</sup> See Proposed Framework, at ¶ 26.

<sup>12</sup> See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat 1376, 1682, § 724(a) (2010) (codified at 7 U.S.C. § 6d(f)); 17 C.F.R. § 22.2 and 22.3(d) (requiring futures commission merchants and derivatives clearing organizations to segregate client collateral and limiting investment of customer collateral to “permitted investments” under 17 C.F.R. § 1.25).

<sup>13</sup> As noted previously, we understand that this would not be the case where the variation margin represents full and final settlement of the prior day’s market moves or exposures.

<sup>14</sup> See Proposed Framework, at ¶ 27.

Thus, the Proposed Framework would penalize these features of central clearing—initial and variation margin that is segregated and subject to client protection laws—rather than recognizing them as exposure reducing, notwithstanding that they have been conceived and implemented under applicable law and regulation that makes centralized clearing less risky. Moreover, these additional capital costs would ultimately be passed on to clients, which, as a result, might forego trading cleared derivatives altogether, seek trading opportunities outside of Basel-member jurisdictions, or seek lower cost alternatives to the extent permitted under applicable law. Such effects could increase, not decrease, risk in the financial system.

For all of these reasons, FIA believes that the Exposure Measure should not apply to a client cleared derivative. That is, neither the client leg (leg 1 in the diagram above) nor the CCP leg (leg 2 in the diagram above) should be included in the Exposure Measure. This would be the appropriate result both from a risk and a regulatory perspective.

#### **IV. Exclude the CCP Leg and Recognize Margin and Netting for the Client Leg**

If the Committee chooses not to adopt the FIA’s proposal to exclude all of a client cleared derivative from the Exposure Measure, the Exposure Measure should at least exclude the CCP leg of a client cleared derivative (leg 2 in the diagram above) and appropriately measure the client leg of a client cleared derivative (leg 1 in the diagram above) by recognizing margin and netting, either by revising the CEM or adopting the NIMM (as adjusted to reflect industry comments).

##### **A. Exclude the CCP Leg from the Exposure Measure**

The CCP leg of a client cleared derivative should be excluded from the Exposure Measure. As the Committee has recognized in the risk-based context, a clearing member bank does not have exposure if the CCP defaults on this leg of the trade because the bank typically does not guarantee the CCP’s performance to the bank’s customer.<sup>16</sup>

Moreover, the Proposed Framework would result in a penalty for client cleared derivatives as compared with bilateral, uncleared derivatives if it includes both the client leg and the CCP leg. Under the Proposed Framework, a derivatives exposure is measured only once in a bank’s bilateral, uncleared derivatives trade, but it is measured twice in a client cleared derivative—once for the client leg (leg 1 in the figure above) and once for the CCP leg (leg 2 in the figure above). This doubles the leverage capital requirement on a client cleared derivative as compared with a bilateral, uncleared derivative.

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<sup>15</sup> See *id.* at ¶ 19. In fact, the Proposed Framework could count that collateral three times in the system: twice for the reasons described above, and a third time in the collateral provider’s Exposure Measure. See *id.* at ¶ 28.

<sup>16</sup> See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* ¶ 99 (Dec. 2010, rev. June 2011). To the extent the clearing member bank guarantees the CCP’s trade with the client, the FIA recognizes that this exposure could also be subject to inclusion in the Exposure Measure.

For example, assume a client enters into a 10 year, \$100 million notional, interest rate swap. The cost of leverage capital associated with a bilateral swap is .90 basis points, post tax ( $100 * .015 * .05 * .12$ ). In order to cover the cost of capital, a bank will need to make 1.35 basis points, pretax, per annum, over the life of the trade. In this example, the client leg and a bilateral swap will attract the same capital footprint and thus require the same pre-tax revenue to cover the cost of capital. If both legs of a cleared swap are included, 2.7 basis points of pre-tax revenue running will be required to cover the cost of leverage capital per year making the cleared derivative significantly more expensive. It is punitive to count both legs of a cleared derivative in the leverage ratio. Such double counting is also at cross purposes with the Group of Twenty (“G20”) mandate to centrally clear derivative transactions.

**B. Recognize Margin and Netting for the Client Leg of a Client Cleared Derivative**

Any methodology used to measure the exposure of a cleared transaction should appropriately capture the margin and netting benefits of client clearing. An adjusted CEM or the NIMM, as adjusted to reflect industry comments, could achieve this objective. However, given the many recognized deficiencies of the CEM, the FIA believes that an appropriately crafted NIMM would more accurately measure the actual exposure of client cleared derivative.

The FIA recognizes that a clearing member bank has some exposure to the client in a client cleared derivative because the bank guarantees the client’s performance to the CCP if the client defaults. However, this exposure is dramatically reduced by margin and the safeguards required for client cleared derivatives, as discussed in sections II and III, and these safeguards should be recognized in the Exposure Measure.

In particular, the clearing member bank requires the client to post high levels of initial margin and settles variation margin on a daily basis pursuant to CCP rules and applicable laws and regulations. These margin requirements reduce both counterparty exposure and the exposure of the underlying contract (that is, market risk) because variation margin is marked-to-market daily—essentially pre-settlement of the contract on a daily basis. Thus, the clearing member bank can use the client’s margin to cover a potential loss on the client’s position, whether it arises from changes in the price of the underlying asset or from default by the counterparty.

Moreover, the client’s margin to clearing members with respect to client cleared derivatives is required to be maintained by the clearing member in segregated accounts with permitted depositories, as defined under applicable law and regulation, and can be invested only in accordance with highly restrictive permitted investment rules. Even if the client defaults, well-defined rules, contractual rights, and procedures are in place for the clearing member bank to assure that the client’s position and margin can be accessed and liquidated by the clearing member.

Notwithstanding these systemic safeguards, the Proposed Framework would use the CEM to measure derivatives transactions, which would significantly overstate the exposure to the client cleared derivative by failing to recognize margin and other safeguards. The CEM was designed for one bilateral trade as principal with a counterparty. It was not designed for a client cleared derivative where the clearing member bank acts as an intermediary and is not



exposed to the market risk of the client's position, other than close-out netting in event of client default, and any such exposure is reduced through strict margin requirements. As discussed above, regulators have long recognized the many deficiencies of the CEM.<sup>17</sup>

Any Final Framework should remedy these deficiencies and recognize the exposure-reducing effects of margin and netting for client cleared derivative. This could be achieved by adjusting the CEM or the NIMM (as adjusted to reflect industry comments). However, given the many recognized deficiencies of the CEM, the FIA believes the NIMM is the better approach. The NIMM attempts to correct for some of the deficiencies of the CEM by distinguishing between margined and unmargined derivatives, providing incentives for over-collateralized transactions, and providing for fuller recognition of netting arrangements in the PFE measure. Thus, the Committee has recognized that "NIMM should be more appropriate to centrally cleared transactions than CEM."<sup>18</sup>

Nonetheless, the FIA believes that the NIMM could be further revised to better reflect the realities of cleared derivatives. The FIA and its member banks are still evaluating the impact of the NIMM on exposure calculations; future industry comments should be carefully reviewed and incorporated into the NIMM before finalizing the leverage ratio Exposure Measure.

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Thank you for considering the concerns and recommendations raised in this letter. If you have any questions or need further information, please contact Jacqueline Mesa, Senior Vice President, Director of International Relations and Strategy, Futures Industry Association, at 1 202-772-3040 or [jmesa@futuresindustry.org](mailto:jmesa@futuresindustry.org).

Respectfully submitted,



Walt Lukken

President & Chief Executive Officer  
Futures Industry Association

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<sup>17</sup> See, e.g., NIMM Consultative Document, at ¶ 6.

<sup>18</sup> Basel Committee on Banking Supervision, *Consultative Document: Capital treatment of bank exposures to central counterparties* ¶ 23 (June 2013, rev. July 2013).

### **About the Futures Industry Association**

Based in Washington, D.C., FIA is the primary industry association for centrally cleared futures and swaps. Its membership includes the world's largest derivatives clearing firms as well as exchanges and clearinghouses from more than 20 countries. FIA seeks to promote best practices and standardisation in the cleared derivatives markets, provide policymakers with an informed perspective on the derivatives markets, and advocate for the interests of its members, its markets and its customers. FIA strives to protect open and competitive markets, protect the public interest through adherence to high standards of professional conduct and financial integrity, and promote public trust and confidence in the cleared markets.