

Wednesday 6 July 2016

**BASEL COMMITTEE ON BANKING STANDARDS (BCBS) CONSULTATIVE DOCUMENT:
REVISIONS TO THE BASEL III LEVERAGE RATIO FRAMEWORK**

Introduction

The World Federation of Exchanges (WFE) is the global trade association that represents more than 200 Financial Market Infrastructures (FMIs), of which more than 100 are Central Counterparties (CCPs) and Central Securities Depositories (CSDs). Our members include exchange groups as well as standalone CCPs¹.

Our members are both local and global, operating the full continuum of Financial Market Infrastructure in both developed and emerging markets. Of our members, 36 percent are in the Asia-Pacific region, 42 percent in EMEA and 22 percent in the Americas. The market capitalisation of entities listed on our member exchanges is \$68.5 trillion, and around \$26 trillion in trading annually passes through the infrastructures our members safeguard².

The WFE works with standard setters, policy makers, regulators and government organizations to support and promote the development of fair, transparent, stable and efficient markets around the World.

The WFE and its members share the Basel Committee's goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence, and promoting economic growth. In that context, WFE appreciates the opportunity to respond to the BCBS' consultative document³ relating to revisions to the Basel III Leverage Ratio framework.

Summary

As the BCBS is aware, FMIs performed well through a range of significant market stress events including the 2008 global financial crisis and - more recently - in the global market volatility seen in August 2015 and at the beginning of 2016. Despite their impressive track record through stressed market conditions, FMIs continue to refine and improve their resilience and ability to manage future market crises as the core function of their offering.

The WFE welcomes well-designed international efforts to enhance and strengthen the resilience of the financial system post-crisis and supports further initiatives that encourage that objective. The WFE has previously publicly expressed support for initiatives such as the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) and the FSB Key Attributes, and has sought to contribute to the international debate on these issues and others – including CCP risk management, recovery and resolution⁴. In doing so, its members have contributed significantly to the strengthening of the system via the implementation of many post-crisis initiatives, including efforts to encourage central clearing of derivatives as per the G-20 direction.

¹ The WFE membership list [can be found here](#)

² As at end 2015

³ [BCBS Consultation Document](#)

⁴ [WFE: CCP Risk Management, Recovery and Resolution – Aligning CCP & Member Incentives](#)

The WFE acknowledges and applauds the BCBS' careful consideration of capital issues generally, and the Leverage Ratio specifically, and in particular recognises that it has listened to stakeholder representations around the design and effect of the rules (which were designed primarily to strengthen banking capital).

However, notwithstanding positive aspects within the most recent consultative document – particularly around the move to a revised SA-CCR method and movement on the liquidation period expected for centrally cleared derivatives - the WFE remains concerned around the effect of some elements of the proposal.

Particularly, we are concerned about the impact of not recognising the exposure-reducing effect of client initial margin on fair, orderly and stable markets - which appears contrary to wider efforts to encourage central clearing of derivatives. We believe that an inappropriate application of requirements on clearing members will have contagion effects in many other parts of the market for whom they clear, with no clear risk benefit. This in turn will have ***knock-on effects on the markets and services WFE members offer***. Specifically it:

- Will force a market exit of some Clearing Members – which has already begun to happen - increasing concentration risk with the remaining entities;
- Will make more difficult for end users (funds, commodities) to use markets to hedge, with up to 60% having already been asked to pay higher fees;
- Will have a knock-on effect on non-Clearing Members in terms of capital – with fewer access points. This will ultimately affect the real economy through medium such as higher food & energy costs and pose greater difficulty in managing retirement funds in addition to other similar negative effects; and
- Will force more trading OTC and lower liquidity on transparent exchanges as it will become uneconomical for market makers and liquidity providers – who make up to 40% of traded volume - to continue contributing liquidity.

In turn lower liquidity on transparent central markets will lead to higher spreads, lower volumes, more volatility and increased risk – for example concentration and capital allocation risk.

Further, we have significant concerns that it will become more difficult to port positions in the event of a Clearing Member default (given it is unlikely that any alternative Clearing Member will want to take on positions if the margins that accompany them have the effect of increasing their own potential future exposure – and therefore capital cost).

Therefore our view is that these capital rules, designed primarily for the banking sector, have a far reaching and potentially negative effect on other parts of the market if not appropriately calibrated and implemented.

Our comments below seek to further elaborate on this issue, setting out our analysis and likely consequences as a result of the proposals remaining unchanged.

General Remarks

Regulated Exchanges and CCPs are a critical part of the global financial markets and play a key role in mitigating risks for all participants in the markets they serve. Exchanges and CCPs performed well through-, and post-, crisis, with this explicitly recognised in many of the G-20 post-crisis reforms. Additionally, they have proven to be part of the post-crisis solution, enabling companies to raise capital and manage risk, helping economies recover and grow following the largest global recession of modern times in addition to offering a bedrock of systemic stability.

The WFE welcomes international efforts to enhance and strengthen the financial system through regulatory reforms that will increase transparency in derivatives markets and reduce systemic risk.

Whilst the well-established and highly regulated exchange traded derivative (ETD) markets didn't contribute to the financial crisis, there are a number of aspects of the post-crisis reform agenda – in both capital, and non-capital, reform measures - that impact those markets. In designing reform measures, it will therefore be important to bear in mind and take into account the existing structure of centrally cleared markets, ensuring reform measures do not bring about effects that are disproportionate and give rise to adverse and unintended consequences on those markets. Failure to do so could compromise the continued offering of price discovery and risk management benefits that liquid and transparent ETD products provide for wholesale financial markets, and the wider economy.

Within the context of the Basel III capital reforms, the WFE supports the proposed adoption of a modified version of the standardised approach for measuring counterparty risk exposures (the “SA-CCR” approach). This is an improvement on the CEM as it recognises the benefit of collateral and netting agreements and appropriately differentiates between margined and un-margined trades.

However, we remain concerned that the modified version – by not allowing for the offsetting of client initial margin - continues to ignore the protections in place for that margin in centrally cleared markets, with a subsequent negative impact on ETD markets overall.

Specific Comments

Exchanges and CCPs have proven themselves to be resilient through the financial crisis, and continue to constantly refine and improve their resilience and ability to manage future market crises. Risk management is the core offering and speciality of WFE members.

As per previous WFE and WFE-member correspondence (18 November 2014⁵, 28 May 2013 and 26 April 2013⁶, and 27 November 2012⁷), and as referred to in a recent Financial Times Op-Ed⁸ of August 2015, WFE members remain concerned around certain aspects of the Leverage Ratio package, notwithstanding recent revised proposals.

WFE members agree with the principle of a Leverage Ratio that is designed to restrict the build-up of leverage in the banking sector to avoid de-stabilising deleveraging processes that can damage the

⁵ [Joint association letter re BCBS Leverage Ratio treatment of initial margin under Basel III](#)

⁶ [WFE letter on BCBS Interim Capital Framework](#)

⁷ [Joint Exchange letter re BCBS Interim Capital Framework](#)

⁸ [WFE et al: Letter to Financial Times](#)

broader financial system and economy. In order to facilitate that, BCBS aims to introduce a simple, understandable and transparent supplementary measure to act as a backstop to risk-based capital standards that ensures broad and adequate capture of both the on- and off-balance sheet sources of banks' leverage. These are of course worthy aspirations.

However, it is critical that - within this - the *total leverage exposure* accurately captures the **actual** off-balance sheet exposures that a banking organisation has to its counterparties, including exposures arising out of centrally cleared derivatives transactions, and that the Leverage Ratio functions in its intended manner as a backstop for centrally cleared derivatives exposures. This is where our concerns continue to lie.

With regard to the specific aspects of the consultative materials:

II.1.1 Adoption of a Modified Version of the Standardised Approach for Measuring Counterparty Credit Risk Exposures (SA-CCR)

The WFE and its members have previously advocated for the move to a SA-CCR model, and as such supports the BCBS proposal to adopt a modified SA-CCR model. However, we do not believe that the move to SA-CCR alone will solve the problems and concerns described below without also including the ability to offset client initial margins. In particular, our comments below focus on two associated aspects.

1) Treatment of Client Initial Margin.

The arguments in many previous WFE, and other, letters and white papers make the technical argument and so we don't revisit those in full here⁹.

Across jurisdictions, there are rules that prohibit segregated client margin being used by the clearing member or CCP for its own purposes¹⁰ – specifically that it must be held in cash or cash-like investments, separately held from firms' other assets. This will be used in the event of default before going to other firms – reducing the Clearing Member's exposure. This is not an insignificant amount. Indeed, according to data available via the CPMI-IOSCO Public Quantitative Disclosure standards for CCPs¹¹, as at 31 December 2015, **more than \$300bn in client segregated initial margin was being held at CCPs globally** with the purpose of protecting client cleared trades on each market. The current Leverage Ratio design has the effect of essentially ignoring these protections.

Further, we note that all CCPs require posting at least daily (and others, twice daily) of variation margin. The Clearing Member is therefore exposed only to the possibility that the market moves in the full (or half) day. This is secured by the posting of collateral in addition to the variation margin – i.e. the client segregated initial margin. As such, the calculation remains relatively conservative as each day there exists a full "reset" for exposures.

⁹ We make reference to several of these in the next section.

¹⁰ For example, under CFTC rules, a Clearing Member must separately account for, and segregate as belonging to the end-user, all money, securities and property it receives from an end-user as margin. See 17 C.F.R. §§ 1.20-1.30; 17 C.F.R. §§ 22.2-22.7; see also CFTC Chairman Timothy Massad, Testimony before the U.S. House Committee on Agriculture (Feb. 12, 2015). Similarly, in the United Kingdom, clearing firms segregate the margin of clients that are provided money protection under the Client Asset Sourcebook ("CASS") regime. See CASS 7.3.1R and CASS 7.4.1R.

¹¹ [CPMI-IOSCO Public Quantitative Disclosure Standards for CCPs](#)

Given this context, our comments are as follows:

- a) Unlike margin posted in many un-cleared derivative transactions, margin that is segregated – as is usually the case for cleared derivatives – may not be leveraged by, and in many cases is outside the ownership and control of, the Clearing Member, and as such can only be described as solely exposure-reducing with regard to that entity's cleared derivatives exposure.
- b) We consider that the continued application to cleared derivatives of no offsets for client initial margin threatens to undermine the G-20 push for more central clearing, damage the health of the clearing ecosystem, and make more difficult for customers to hedge their risk.
- c) Further, it is likely that, in the event of a Clearing Member default, it will be less attractive to port positions if the effect – in also accepting the initial margins held to service those positions – would be to raise capital requirements for the rescuing member. This concern is significant and was recently raised by CFTC Chairman Timothy Massad¹²:

“Let me make clear that I support strong capital requirements, but I do think we must consider the effects the leverage ratio may have on clearing. This is particularly true in the context of a default by a clearing member. That is, the other clearing members may be reluctant or unable to take on the customers of a defaulting clearing member, or to bid for positions in an auction, even though those positions are accompanied by suitable margin to mitigate default risk, because that margin is not credited against its leverage ratio. That could increase the risk arising from the default, in what could already be a stressed market.”

- d) In addition, the inclusion of off-balance sheet exposures does not seem consistent with other parts of the Leverage Ratio package (for example, segregated initial margin can be subtracted for agency securities financing transactions), nor does it appear consistent with accounting principles. Specifically, off-balance sheet exposures are not subject to US-GAAP accounting principles, and are a *calculation* of exposures, not a *measure of riskiness* of the exposures.
- e) We contend that the Leverage Ratio appropriately recognises the exposure created by the Clearing Member's guarantee as an off-balance sheet exposure, but then inappropriately fails to recognise the segregated liquid margin posed by the customer as reducing that off-balance sheet exposure.

It is our view that the move to SA-CCR alone will not address these concerns, and that ***it is inappropriate not to recognise the exposure reducing effect of segregated margin in the context of centrally cleared derivatives transactions; the Leverage Ratio's total leverage exposure ought therefore to recognise that reduction.***

Should a full initial margin offset not be acceptable to the BCBS, an alternative solution may be an offset for initial margin held by the CCP. This would at least part-way satisfy some of the concerns as outlined in this submission, and would also have the advantage that CCP-held margin could meet the standards applied to securities financing transaction collateral to be offsetting, addressing the consistency concern.

¹² [CFTC Chairman Timothy Massad's Speech: 7 June 2016](#)

2) **Maturity Factor for Client Cleared Trades – Margin Period of Risk (MPOR).**

The WFE acknowledges the proposal in the document to move to a sliding scale MPOR 20-5 days (the 5 day MPOR applying only to certain centrally cleared derivatives). We applaud the BCBS for this step given the previous version of the proposal would have applied a 10-day MPOR for centrally cleared derivatives.

Notwithstanding this positive movement, we respectfully note that it continues to not take into account the market structure for ETDs (where a considerably shorter liquidation period could be achieved).

The WFE and its members have previously (in the letter of several WFE members to the BCBS, CPSS and IOSCO of 26 April 2013¹³) suggested that a 5-day MPOR when calculating clearing member exposures to clients for CCP cleared transactions would greatly reduce incentives to use more standardised, liquid and transparent products. Further, we suggested an alternative approach that is simple, transparent and prudentially sound, yet flexible enough to avoid unintended consequences that would undermine the goals of derivative market reform or impede product innovation.

Whilst we note that, in general, a lower MPOR for ETD supports the G-20 objective for all standardized OTC derivative contracts to be traded on exchanges (or electronic trading platforms where appropriate) because it incentivises ETD trading through offering lower capital requirements for Futures versus OTC, as alluded to above, we consider the initial margin offset to be the more powerful tool. It is therefore our belief that the reduction in MPOR to 5 days, whilst broadly positive, is only really effective in conjunction with the initial margin offsets. Failure to pair these tools will undermine the effectiveness of the Leverage Ratio in relation to centrally cleared derivatives, and would appear inconsistent with the wider goals of the G-20 and other international standards¹⁴.

II.1.2 Impact Assessment on the Client Clearing Business Model

As operators of markets and post-trade infrastructures, we believe that a healthy and thriving market place has to have regard to the different parts of the ecosystem and it is important to have a diversity of participants making, and sharing, liquidity. Liquidity on lit central markets ensures a fairer and more transparent price formation process – important for the integrity of, and confidence in, those markets. This is particularly important as economies and markets continue to recover and grow post-crisis. As such it is necessary to look at the effect of capital requirements on different parts of the market ecosystem in aggregate in order to assess impact on the wider market as a whole.

Whilst the BCBS proposals do not directly apply to exchanges and CCPs, they nevertheless impact the ability of participants in the wider ecosystem to perform the liquidity and risk sharing functions that are critical to the functioning of markets and the achievement of the objectives of encouraging more exchange trading and central clearing. As discussed below, the likely structural impacts would include increased capital requirements, fewer clearing members, and higher costs of hedging and a lower propensity to hedge (therefore reducing the number and variety of overall participants).

¹³ [WFE letter on BCBS Interim Capital Framework](#)

¹⁴ As set down in the [CPMI-IOSCO PFMI](#)s – which require a MPOR that is commensurate with the risk and liquidity profile of each product

It is also clear that adverse effects on Clearing Members and the wider client base of those CCP members would have an adverse knock-on effect on the *quality* of markets offered by WFE members. This would include encouraging higher spreads, lower volumes, more volatility and increased risk – for example concentration, porting and capital allocation risk – ultimately impacting the ability of FMIs to continue facilitating delivery of the G-20 mandate.

In recognition of the priority placed by WFE members on post-trade matters – including those that are capital related – in early 2016 the WFE launched a new Post-Trade Working Group (PTWG). This working group consists of senior representatives from exchanges and CCPs across each of the WFE regions (APAC, EMEA and the Americas) and exists to provide technical input to WFE policy matters.

The BCBS consultation on the Leverage Ratio has been extensively discussed within this group and the arguments we set out within this document are the result. However, given the sensitive nature of the types of data that can be drawn on a per-entity basis to feed into the specific BCBS request for information, **CCP and/or exchange-specific data will be provided through individual and private bilateral submissions from WFE members as opposed to provided through this response.**

Nevertheless, in the below section, we refer to other publicly available materials that describe and demonstrate the effects within other pockets of the broader markets user-base. In particular we note the following:

Relating to **Clearing Members**:

- The capital effect on the continued participation by Clearing Members has been well documented – with the Futures Industry Association (FIA) suggesting that¹⁵, over the 10-year period between 2004 and 2014, the Clearing Member community in the US has decreased from 190 firms to 76 firms. CFTC financial data of FCMs and retail foreign exchange dealers (financial reports as at 31 March 2016) shows a further reduction to 70¹⁶.

Relating to **Market Makers** and **Liquidity Providers**:

- According to ABN et al¹⁷, Market Makers and Liquidity Providers represent 25-40% of turnover on global markets. With regard to the effects on Clearing Members of inappropriately applied capital requirements, it is suggested that it would become uneconomical for Market Makers and Liquidity Providers to provide liquidity on trading venues, leading to higher spreads, lower volumes, more volatility and greater systemic risk. Further, it is discussed that a number of traditional Clearing Members have already ceased client clearing activities or are reassessing their business models, resulting in a further lack of choice for end-users.

¹⁵ [FIA Testimony to US House of Representatives Committee on Agriculture, Subcommittee on Commodity Exchanges, Energy and Credit](#)

¹⁶ [CFTC Financial Data as at 31 March 2016](#)

¹⁷ [Industry letter to BCBS of 27 October 2015](#)

Relating to **asset managers**:

- According to SIFMA¹⁸ – the ability for asset managers to hedge risk / reduce volatility through using cleared derivatives will be compromised through failing to recognise the exposure reducing effect of segregated initial margin. Further, SIFMA surveyed its membership to determine the effect on the ability to access clearing services. The results showed that its members were experiencing significantly higher prices and reduced access to clearing services. Further, in the previous 24 months:
 - o 60% of respondents had been asked to pay higher clearing fees for Interest Rate Swaps (IRS);
 - o 50% had been asked to cap the notional amount of IRS outstanding with a clearing member; and
 - o 30% of IRS users had been forced to terminate relationships with clearing firms.

Relating to the **managed funds** and **commodities businesses**:

- According to the CMC and MFA¹⁹, a modification from CEM to SA-CCR with offsets for segregated margin would more accurately capture the actual economic exposures that Clearing Members incur when providing clearing services. Without this, Clearing Members would likely need to increase prices on end-users by 5 times (*estimated*), reducing the ability for financial (e.g. investment funds, pensions, university endowments etc.) and commercial end users (e.g. farmers, manufacturing) to manage risk. This in turn will mean either reducing hedging activity, causing price volatility so that food, gas and other consumables become more unaffordable, or paying higher fees for the clearing service – also likely being passed down to the end-user/consumer. Furthermore, segregated initial margin has meant it has become easier for Clearing Members to port positions of failing member. If this now will lead to an increase in capital costs for the receiving Clearing Member, it is reasonable to assume that it would be less inclined to take on the positions and new margin in that situation.

The aggregate effect of this on the wider functioning of the markets that WFE members operate and clear for would therefore be considerable.

For example, and as has been demonstrated above and by various public studies and comment letters to date, the effect will be to drive banks out of the clearing business, which in turn will make it uneconomical for Market Makers and Liquidity Providers to provide liquidity, as a result making it uneconomical / more difficult for end-users to use markets to manage risk.

In turn, this could result in lower exchange volumes and CCP-cleared transactions, higher spreads, more volatility and greater risk, and would likely serve to damage FMIs' ability to continue to deliver on the G-20's aspiration to maintain and enhance fair, orderly and stable markets going forward.

¹⁸ [SIFMA letter to BCBS of 1 February 2016](#)

¹⁹ [CMC and MFA letter to BCBS of 2 November 2015](#)

Conclusion

The WFE and its members are committed to ensuring the trading and clearing environments they operate are secure, stable and able to withstand shocks.

Investor confidence in public markets is crucial for the industry and, as markets evolve – and as G20 mandates continue to be implemented encouraging greater central clearing of financial markets – legislators and FMIs should work together to ensure that risks are appropriately mitigated without undue or unintended consequences.

We are concerned that the failure in the Leverage Ratio to recognise the exposure-reducing effect of segregated client initial margin is inconsistent with:

- The G-20 push for more derivatives to be centrally cleared - undermining G-20 goals;
- The accounting treatment of off-balance sheet exposures; and
- The treatment of other parts of the Leverage Ratio (i.e. segregated initial margin is allowed to be subtracted for agency securities financing transactions).

Further, we suggest that the adoption of a more risk-based MPOR calculation for ETDs that are centrally cleared and that is commensurate with the risk and liquidity profile of each product would be more consistent with international standards as set down in the CPMI-IOSCO PFMIs.

Our analysis, and that of others, suggests that an inappropriate application of capital requirements will dis-incentivize clearing members to continue offering clearing services and liquidity - having contagion effects in many other parts of the market for whom they clear - for no clear risk benefit. This in turn will have knock-on effects on ***the markets and services WFE members offer***. Specifically it:

- Will force the market exit by some Clearing Members – which has already begun happening - increasing concentration risk with the remaining entities;
- Will make more difficult for end users (funds, commodities) to use markets to hedge, with up to 60% having already been asked to pay higher fees;
- Will have a knock-on effect on non-Clearing Members in terms of capital – with fewer access points, and ultimately affecting the real economy through higher food/energy costs, greater difficulty managing retirement funds, etc; and
- Will force more trading OTC, lowering liquidity on transparent exchanges, particularly given it will become uneconomical for market makers and liquidity providers – who make up to 40% of traded volume - to continue contributing liquidity.

Lower liquidity on transparent central markets will lead to higher spreads, lower volumes, more volatility and greater systemic risk. Further, we are concerned that it will make it more difficult to port positions in the event of a Clearing Member default (given it is unlikely that any alternative



Clearing Member will want to take on positions if the margins that accompany them have the effect of increasing their own potential futures exposure – and therefore capital cost).

All of this is clearly at odds to the wider G-20 mandate for no additional risk benefit.

As such, we respectfully advocate for a **further modification to the SA-CCR method to INCLUDE the offsetting of segregated client initial margin for centrally cleared derivative transactions as this would more accurately capture the market structure for centrally cleared derivatives and the actual economic exposures that Clearing Members incur when providing clearing services.**

However, should a full initial margin offset not be acceptable to the BCBS, we suggest an alternative solution may be an offset for initial margin held by the CCP. This would at least part-way satisfy some of the concerns as outlined in this submission, and would also have the advantage that CCP-held margin could meet the standards applied to securities financing transaction collateral to be offsetting, addressing the consistency concern.

Ultimately, we are working towards the shared objectives of achieving fair, robust and resilient markets in which investors can have confidence. In that regard, the WFE and its members stand ready to work with national and international agencies to ensure this.