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

Re: Treatment of Segregated Initial Margin in the Calculation of Centrally Cleared Derivatives Exposures under the Basel III Leverage Ratio Framework

Dear Sirs and Madams:

The Asset Management Group ("AMG")[1] of the Securities Industry and Futures Markets Association writes to express our concern that the derivatives exposure measure contained in the recently issued Basel III Leverage Ratio Framework and Disclosure Requirements (the "LR Framework")[2] may substantially reduce our members' ability to hedge risk and reduce volatility in the funds they manage through the use of cleared derivatives. Our member firms advise and manage registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds. As such, our members represent a substantial portion of the "buy side." They use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge business risks such as changes in interest rates, exchange rates, and commodity prices.

Consistent with Title VII of the Dodd Frank Act, and similar laws in other jurisdictions, funds and other derivatives end-users enter into derivatives contracts cleared through central counterparties ("CCPs"), commonly referred to as clearing houses, acting through clearing brokers that are members of CCPs ("Clearing Firms"). Clearing Firms, which are typically part of prudentially regulated financial institutions, guarantee the end-user's performance to the CCP, which is the end-user's counterparty on the derivative contract. In addition, the end-user secures its own performance by posting collateral, referred to as segregated initial margin, with the

[1] AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion.

[2] Basel Committee on Banking Supervision, Basel III Leverage Ratio Framework and Disclosure Requirements (BCBS 270) (Jan. 12, 2014), available at http://www.bis.org/publ/bcbs270.htm.

Clearing Firm for the benefit of the CCP.[3] It is important to note that the Clearing Firm is not trading on its own behalf when it provides the guarantee of the end-user's performance to the CCP; rather the transaction at issue is driven by the end-user's desire to manage its commercial risks through the use of a cleared derivative.

The LR Framework fails to adequately recognize that segregated initial margin cannot be used as leverage by the Clearing Firm and that, for the Clearing Firm, the sole purpose and effect of segregated initial margin is to reduce the extent of its guarantee to the CCP. As a result, the LR Framework has been applied in a manner that severely overstates the exposures of Clearing Firms with respect to such guarantees, and consequently imposes outsize capital requirements on Clearing Firms. Unless the LR Framework is modified to appropriately recognize the exposure-reducing effect of segregated initial margin, our members and other end-users face significantly higher clearing fees and reduced ability to enter into cleared derivatives transactions.

Rules that dis-incentivize the clearing of derivatives run counter to G-20 commitments established in 2009,[4] and would undermine a key aspect of post-financial crisis reform: ensuring a transparent derivatives market structured in a manner that promotes clearing and permits efficient netting and settlement of trades, even in times of financial stress. We thus urge the members of the Basel Committee on Banking Supervision (the "Committee") to clarify that Clearing Firms (i) may account for segregated initial margin in calculating their exposure on cleared derivatives transactions and, relatedly, (ii) need not include segregated initial margin in their calculation of on-balance sheet items.

The sole purpose and effect of segregated initial margin is to reduce the Clearing Firm's exposures.

Pursuant to applicable law, CCPs establish rules for the calculation and collection of margin from end-users through Clearing Firms. Margin refers to the amount of cash or other collateral that an end-user must deposit into its account with a Clearing Firm at the time of entry into a cleared derivatives contract, and on an ongoing basis through the life of the transaction.[5] Segregated initial margin refers to the portion of the margin that the Clearing Firm collects from the end-user at the time the end-user enters into the derivatives contract. Like all margin, segregated initial margin secures the end-user's performance of the derivatives contract.

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[3] End-users also make daily mark-to-market payments, referred to as variation margin, pursuant to the CCP's instruction to the Clearing Firm. Under the LR Framework, ¶ 25, cash variation margin can, subject to conditions, be treated as pre-settlement payment that reduces the Clearing Firm's exposures.

[4] *See* G-20 Leaders' Statement, The Pittsburgh Summit (September 25, 2009).

[5] The required margin is typically set as a percentage of the total notional value of the derivatives contract, which is determined by the CCP pursuant to robust risk management processes. The margin calculation is continuously reviewed and updated based on a range of factors, such as general market volatility and the volatility of the particular cleared derivatives contract.

Clearing Firms typically also impose their own additional segregated initial margin requirements on end-users.

Applicable law in the United States and elsewhere makes clear that segregated initial margin cannot be used, pledged or re-hypothecated by the Clearing Firm for its own business purposes, even when held in the end-user's account at the Clearing Firm.[6] Regulations imposed by the U.S. Commodity Futures Trading Commission require that segregated initial margin be:

- deposited in bankruptcy-remote accounts that are clearly identified as segregated accounts holding customer collateral;
- invested only in specified, safe and highly liquid investments;[7] and
- used solely to meet the obligations of the relevant end-user to the relevant CCP.

In short, there is a robust firewall between segregated initial margin and the Clearing Firm's own funds and assets. For a Clearing Firm, the sole purpose and effect of segregated initial margin is to reduce the extent of its guarantee to the CCP. Crucially, segregated initial margin for cleared derivatives cannot be used to lever the Clearing Firm.

The LR Framework overstates the exposures of Clearing Firms, requiring them to hold outsized capital.

The current LR Framework does not adequately recognize the limited purpose and effect of segregated initial margin. Instead, it has been applied in a manner that significantly omits the exposure-reducing effect of such segregated collateral.

The LR Framework establishes a Supplementary Leverage Ratio that, in broad terms, requires prudentially regulated financial institutions to hold a minimum amount of tier 1 capital against their total leverage exposure. Total leverage exposure consists of balance sheet items as well as certain off-balance sheet exposures, including exposures on cleared derivatives. Derivatives exposures are principally quantified through a calculation that adds the fair value of a derivative to potential future exposures on that derivative. Potential future exposures are calculated by multiplying the notional principal amount of the derivative by an "add-on factor." The size of the add-on factor varies based on the type of derivative and its residual maturity. The longer the maturity, the higher the add-on factor.

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[6] *See* 17 C.F.R. §§ 1.20-1.30 (futures) and 17 C.F.R. §§ 22.2- 22.7 (cleared swaps). In jurisdictions outside the United States, similar restrictions may be imposed either by rule or by contract. *See, e.g.*, U.K. Financial Conduct Authority, Client Assets Sourcebook, §§ 7.3.1–7.3.2.

[7] Permitted investments may include obligations of the United States and its subdivisions and agencies, bank deposits, and interests in money market mutual funds. *See, e.g.*, 17 C.F.R. § 1.25.

The LR Framework states that, "[a]s 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] This "general rule" has been applied to prevent Clearing Firms from offsetting their exposure on a cleared derivative by the segregated initial margin received from an end-user. Yet, the rationale for the LR Framework's "general rule" on collateral makes clear that it should not be applied to segregated initial margin.

In this regard, the LR Framework explains its treatment of collateral by noting that while collateral may "reduce[] counterparty exposure . . . it can also increase the economic resources at the disposal of the bank, as the bank can use the collateral to leverage itself."[9] This risk that collateral may be used as leverage by an institution is the sole stated basis for preventing institutions from netting exposures against collateral. This logic may make sense as a "general rule," outside the context of initial margin. However, there is no basis for its application to segregated initial margin, which cannot be used by the Clearing Firm to leverage itself.

The treatment of segregated initial margin is also inconsistent not only with the treatment of cash variation margin,[10] but also with the treatment of analogous payments in other contexts where a prudentially regulated institution acts as a mere agent and guarantor between two parties. In calculating its securities financing transactions exposures, for example, a bank acting as an agent and guarantor only guarantees, and is only required to recognize, "any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided."[11] Yet while a Clearing Firm acting as an agent and guarantor in a cleared derivatives transaction effectively guarantees only the difference between the value of the cash collateral provided by the end user and the end-user's total exposure, a Clearing Firm's exposure calculation is not similarly limited.

The issue is compounded in jurisdictions that follow U.S. Generally Accepted Accounting Principles ("U.S. GAAP") and other accounting standards that require segregated cash initial margin to be treated as a balance sheet item. In such jurisdictions, segregated cash initial margin actually *increases* the regulatory leverage of the Clearing Firm, notwithstanding that its true effect is to reduce the economic exposure, and thus the economic leverage, of that Clearing Firm. Because U.S. GAAP does not require segregated initial margin in the form of securities to be treated as a balance sheet item, Clearing Firms are perversely incentivized to prefer margin in the form of securities rather than cash. However, such a preference for non-

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[8] LR Framework at ¶ 23.

[9] LR Framework at ¶ 22.

[10] As noted in footnote 3, above, cash variation margin can, subject to conditions, be treated as a pre-settlement payment that reduces the Clearing Firm's exposures.

[11] LR Framework at ¶ 35-36.

cash margin may present significant costs and operational hurdles, particularly for fund managers that seek to comply with the EU's Alternative Investment Fund Manager Directive.[12]

Unless the LR Framework is clarified, end-users will face rising fees and increased risks.

The LR Framework's failure to expressly recognize the unique nature and effect of segregated initial margin will drastically increase the cost of providing Clearing Firm services, rendering uneconomic the current fee structure of Clearing Firms.[13] As a result, Clearing Firms will almost certainly substantially raise fees.

Based on conversations with Clearing Firms, our members are concerned that clearing fees will increase by such an extent that the use of long-tenor derivatives would become uneconomic in many cases. Without access to these tools for risk management, investment portfolios would be left fully or partially unhedged, increasing downside risk. Members may also withdraw from the cleared derivatives market entirely. The net effect will be increased risk and volatility in fund performance, ultimately penalizing fund investors and beneficiaries by reducing the potential risk-adjusted return of a fund.

The negative impact of the LR Framework on cleared derivatives would be amplified for end-users that routinely use long-tenor derivatives.

Fee increases would be particularly severe for end-users that take long-term directional positions to hedge risk. Many AMG members, including the managers of pension funds, private equity and other closed-end funds, and endowments, trade over long-term horizons to achieve long-run investment targets. These managers must hedge risks over the life of their funds, or over the substantial periods for which they hold investments. As noted, however, the add-on factor applied to long-maturity derivatives is many times higher than that applicable to short-term instruments,[14] penalizing the clearing of longer tenor instruments.

[12] Among other things, the EU's Alternative Investment Fund Managers Directive requires that such instruments be held in custody by a depository rather than being held directly by a fund, its manager or an affiliate of its manager, which presents an additional layer of operational management. Moreover, depositories are strictly liable for losses of financial instruments, which increases the fees they charge to hold such instruments.

[13] From their discussions with Clearing Firms, our members understand that, to achieve an economic return on capital under the LR Framework as currently applied, Clearing Firms would have to generate *profits* on clearing many long-term derivatives contracts that are substantially in excess of gross *revenues* currently generated by clearing fees. We encourage the Committee to seek further quantitative data from Clearing Firms on the potential impact of the LR Framework on clearing fees.

[14] For interest rate derivatives, the LR Framework add-on factors range from 0.0% (where the residual maturity is one year or less) to 1.5% (where the residual maturity is greater than five years). For foreign exchange derivatives, the add-on factors for the same maturities are 1.0% and 7.5%, respectively.

In addition, certain pension funds and state and local government pension funds may face particularly severe fee increases (or be effectively excluded from the derivatives markets) due to the current challenges imposed by Clearing Firms receiving netting opinions. Without such a netting opinion, pension fund positions have to be treated as uncollateralized exposures, thus increasing associated fees and impairing access to derivatives markets.

The current treatment of segregated initial margin under the LR Framework may have a negative impact on systemic risk.

Because segregated initial margin cannot be used by a bank to increase its leverage, the substantial harms referenced above will not be offset by any corresponding benefit in limiting systemic risk. To the contrary, the LR Framework as currently applied to segregated initial margin may have a negative effect on systemic risk in at least three ways.

First, increased costs may drive Clearing Firms from the business. This concern is not merely hypothetical: the Bank of New York Mellon and the Royal Bank of Scotland have already announced plans to wind down substantial portions of their derivatives clearing businesses. The market for Clearing Firms is highly concentrated, with 15 Clearing Firms accounting for 82% of U.S. customer segregated assets.[15] Further concentration would increase systemic risk by concentrating derivatives clearing activities in a smaller number of banks. The effects of any pullback are likely to be particularly severe for end-users hedging long-term risk as Clearing Firms focus on clearing short-term trades that attract lower capital requirements.

Second, Clearing Firms may be dis-incentivized from establishing collateral requirements in excess of the minimum levels required by CCPs, creating increased uncollateralized exposure. In addition, as noted above, in jurisdictions with accounting rules that require segregated cash initial margin to be recognized as a balance sheet item, Clearing Firms will have an incentive to receive collateral in the form of securities rather than cash.

Third, end-users may be forced to seek out bilateral, uncleared trades to the extent they remain available under applicable law. Alternately, they may be forced to hedge risk by rolling over a series of short-term derivatives contracts. The use of such strategies would increase the basis risk of end-users.

Thus the current treatment of segregated initial margin is inconsistent with both the specific rationale stated in the LR Framework and the Committee's larger systemic risk objectives.

[15] *See* U.S. Commodity Futures Trading Commission, Financial Data for FCMs (September 30, 2014), available at http://www.cftc.gov/MarketReports/FinancialDataforFCMs/index.htm.

The Committee should act swiftly to clarify the treatment of segregated initial margin under the LR Framework.

The Committee has several options available to clarify the treatment of segregated initial margin under the LR Framework. The Committee could amend the text of the LR Framework to expressly recognize the exposure-reducing effect of segregated initial margin. Indeed, the Committee has already announced that the LR Framework may be recalibrated prior to finalization of the Supplementary Leverage Ratio.[16] The Committee has also suggested that it would consider revising derivative exposure calculations under the LR Framework to conform with recently released exposure calculations used under the Committee's risk-based capital guidelines, which do expressly recognize the exposure-reducing effect of segregated initial margin.[17]

Perhaps the simplest course of action, however, would be to issue a "frequently asked questions" (FAQ) document clarifying that the LR Framework permits the netting of collateral where it is subject to legal or contractual restrictions that prevent it from being used as leverage by the relevant Clearing Firm. As noted, the LR Framework only provides a "general rule" on the treatment of collateral, one that is justified by policies that simply do not apply to segregated initial margin.

Such a clarification would also be consistent with the requirement that Clearing Firms recognize only their "exposure resulting from the[ir] guarantee" of the end-user's performance. The effective size of that exposure is the difference between the end-user's total exposure on the contract and the segregated initial margin, which is required by, and accepted on behalf of the CCP as security for the end-user's obligation, and which therefore takes the place of the guarantee provided by the Clearing Firm.

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In conclusion, AMG urges the Committee to take steps to ensure that the LR Framework is applied in a manner that recognizes the exposure-reducing effects of segregated initial margin. In particular, the Committee should issue an FAQ, amend the LR Framework, or take other appropriate action to clarify that Clearing Firms (i) may account for segregated initial margin in calculating their exposure on cleared derivatives transactions and (ii) need not include segregated initial margin in their calculation of on-balance sheet items. We note that other market

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[16] *See* Basel Committee on Banking Supervision, Press Release: Amendments to Basel III's leverage ratio issued by the Basel Committee (January 12, 2014), available at http://www.bis.org/press/p140112a.htm. The Committee also emphasized that it will "closely monitor accounting standards and practices to address any differences in national accounting frameworks that are material to the definition and calculation of the leverage ratio," *id*., and we urge the Committee to do so in connection with the treatment of segregated cash initial margin under U.S. GAAP.

[17] *See* Basel Committee on Banking Supervision, Standardized Approach for Measuring Counterparty Credit Risk Exposures (BCBS 279) (April 2014), available at http://www.bis.org/publ/bcbs279.htm.

participants, including Clearing Firms and CCPs, have made similar requests either individually or through trade associations;[18] we fully endorse their submissions.

We appreciate the Committee's consideration of our concerns and stand ready to provide any additional information or assistance that the Committee or its Secretariat might find useful. Should you have any questions, please do not hesitate to contact Matt Nevins at 212-313-1176.

Sincerely,

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cc: Norah Barger, Senior Adviser, Board of Governors of the Federal Reserve System
Sviatlana Phelan, Board of Governors of the Federal Reserve System

Hon. Timothy G. Massad, Chairman, Commodity Futures Trading Commission
Hon. Sharon Y. Bowen, Commissioner, Commodity Futures Trading Commission
Hon. J. Christopher Giancarlo, Commissioner, Commodity Futures Trading Commission
Hon. Mark Wetjen, Commissioner, Commodity Futures Trading Commission

[18] *See* Letter from Walter Lukken (Futures Industry Association) to the Committee, November 18, 2014.

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