

February 1, 2016

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
SWITZERLAND

Re: Higher Prices and Reduced Access to Clearing Experienced by Asset Managers Due to the Basel Leverage Ratio's Failure to Recognize Exposure-Reduction of Client Segregated Initial Margin

Dear Mr. Coen:

The Asset Management Group (“AMG”) of the Securities Industry and Financial Markets Association (“SIFMA”) writes to express our concern that the Basel Leverage Ratio’s failure to take into account the exposure-reducing effect of segregated initial margin for clearing firms is impairing AMG members’ ability to hedge risk and reduce volatility through the use of cleared derivatives. AMG members are U.S. asset management firms whose combined global assets under management exceed \$34 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. They use futures and cleared swaps, as well as other derivatives, for a range of purposes, including as a means to manage or hedge investment risks such as changes in interest rates, exchange rates, and commodity prices.

We understand that the Basel Committee on Banking Supervision (the “Committee”) is considering replacing the Current Exposure Method with a new method for calculating derivatives exposures for purposes of the Basel Leverage Ratio, the Standardized Approach for Counterparty Credit Risk. In this context, we understand from AMG’s meetings with banking and derivatives regulators that information related to the impact of the Basel Leverage Ratio on end users would be useful in the Committee’s consideration of these issues. For this reason, we conducted a survey of AMG members to determine the effect of the Basel Leverage Ratio’s failure to recognize the exposure-reducing effect of segregated margin on their ability to access clearing services.

Survey results demonstrate that AMG members currently are experiencing significantly higher prices and reduced access to clearing services due to this failure to recognize the exposure-reducing effect of segregated margin, as detailed in this letter. For example, in the last 24 months, 60 percent of survey respondents have been asked to pay higher clearing fees for interest rate swaps, 50 percent of respondents have been asked to “cap” the notional amount of their interest rate swaps outstanding with a clearing firm, and 30 percent of interest rate swap users have been forced to terminate relationships with clearing firms (and

seek clearing services elsewhere, if possible). Clearing firms have informed AMG members that these changes are primarily due to higher capital charges as a result of the Basel Leverage Ratio.¹

AMG members believe that the failure to recognize the exposure-reducing effect of segregated initial margin in cleared derivatives transactions makes clearing banks' leverage ratio requirements needlessly higher than they should be. That is, we are not suggesting that capital standards should be "weakened" or that cleared derivatives exposures be "exempt" from the Basel Leverage Ratio. Rather, the Basel Leverage Ratio's failure to take in account the exposure-reducing effect of segregated initial margin results in the measurement of "total leverage exposure" being unnecessarily higher than clearing firms' actual economic exposure, and in turn, that overstatement is having unnecessarily negative effects on end users. For these reasons, we believe the Basel Leverage Ratio should be amended to recognize the exposure-reducing effect of segregated margin.

Part I of this letter describes how the Basel Leverage Ratio unnecessarily fails to recognize the exposure-reducing effect of client segregated initial margin and how the aspects of client segregated initial margin for cleared derivative transactions warrant recognition. Part II of this letter summarizes the AMG member survey results, which show that this failure is already having an adverse effect on AMG members.

I. The Basel Leverage Ratio Unnecessarily Fails to Recognize the Exposure-Reducing Effect of Client Segregated Initial Margin

Consistent with Title VII of the Dodd Frank Act, and similar laws in other jurisdictions, funds and other derivatives end-users wishing to manage their investment risks 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 subsidiaries of financial institutions subject to the Basel Leverage Ratio on a consolidated basis, guarantee the end-user's performance to the CCP, which is the end-user's counterparty on the derivative contract. The clearing firm's guarantee of the end-user's performance to the CCP functions as a backup guarantee if, and to the extent that, the end-user defaults and the value of posted margin is not adequate to cover the end-user's obligation to the CCP.

Parties to a cleared derivative post cash variation margin every day, and for some even twice a day, to secure the full amount that is owed under the contract based on mark-to-market value, also known as the current exposure. Because of the daily or sometimes twice-daily posting of variation margin, the clearing firm remains exposed only to the possibility that market values will move in the one day (or half day) between the last posting of variation margin and the moment the end-user client defaults on its derivatives contract. The end-user secures this remaining potential future exposure of the clearing firm by posting a fixed pool of collateral in addition to variation margin, referred to as client segregated initial margin. The client or end-user posts this segregated initial margin to the clearing firm, which then on-posts such margin to the CCP, with any excess beyond CCP-required minimums typically remaining in a client segregated margin account at the clearing firm.

In the United States, client segregated margin legally may not be used, pledged, or hypothecated by the clearing firm or the CCP for its own business purposes; instead, it must be held in cash or specific, very safe, and highly liquid investments managed "with the objectives of preserving principal and maintaining

¹ Moreover, as detailed below, the survey shows results that are directly correlated with the treatment of derivatives under the Basel Leverage Ratio: impacts are more pronounced for transactions that have a greater leverage ratio impact, including transactions in which cash initial margin is posted, low frequency trading transactions, and "directional" trading transactions.

liquidity,” so that it can quickly be monetized to pay for any client losses, if needed.² Moreover, the segregation rules established by the Commodity Futures Trading Commission ensure that (1) the client margin is held separately from, and accounted separately from, the clearing firm’s other assets or assets under management; and (2) the client margin is “bankruptcy remote” from the clearing firm’s assets, so that, if the clearing firm were become insolvent, its creditors would not have rights to any of the client margin ahead of the client itself or CCP.³ As a matter of practice, in the event of an end-user’s default a CCP will look to all of the client’s segregated margin for payment before seeking to obtain additional funds from the clearing firm based on its guarantee to the extent needed. Client segregated margin reduces the clearing firm’s exposure in the event of the default of its client, since, as noted, the clearing firm as a matter of practice will not have any payment obligation unless the client defaults and the value of the client segregated margin is not sufficient to cover the client or end-user’s obligation.

Moreover, we believe the reasons articulated for failing to recognize the exposure-reducing effect of client segregated margin are misplaced. First, the Basel Leverage Ratio framework states that while collateral “reduces 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.” The concern seems to be that a bank could use collateral in a way that might make the collateral unavailable if and when the bank’s counterparty defaults. However, that is not the case for client segregated margin provided in a cleared derivative transaction. For instance, under U.S. law, strict segregation rules and limitations on reinvestment ensure that the client margin is available when needed to reduce any first losses caused by a client or end-user’s default.

Second, while we understand that leverage ratios are not intended to be sensitive to risk, they are intended to correlate a bank’s capital to its *actual exposures*. Traditionally, leverage ratios have measured such exposures based solely on the value of on-balance sheet assets as determined under relevant accounting principles, such as U.S. Generally Applicable Accounting Principles (“U.S. GAAP”). The Basel Leverage Ratio extends this measure of exposure to capture off-balance sheet exposures as well as on-balance sheet assets. Unlike on-balance sheet assets, off-balance sheet exposures are not measured using accounting principles; instead, they are determined based on an assessment of an activity’s *actual economic exposure*. In this context, where actual economic exposure is reduced by segregated collateral that is available to absorb first losses – as is the case with client segregated margin – then the Basel Leverage Ratio should recognize that exposure-reducing effect. Indeed, in analogous circumstances involving securities financing transactions, the Basel Leverage Ratio expressly recognizes that a bank can offset the off-balance sheet exposure attributable to the guarantee it provides in such transactions by the value of collateral it receives.⁴

Third, a clearing firm’s guarantee to the CCP in cleared transactions has sometimes been mischaracterized as “unlimited.”⁵ Far from being unlimited, a clearing firm’s guarantee obligation is limited to the value of one day’s or in some cases a half a day’s move in market prices, less the value of initial margin posted by the client. This is so because the client posts cash variation margin once or for some even twice a

² 17 C.F.R. § 1.25.

³ 17 C.F.R. §§ 1.20-1.30 (futures) & 22.2-22.7 (cleared swaps). 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.

⁴ See Letter to Basel Committee on Banking Supervision from Commodity Markets Council and Managed Funds Association, at 5-6 (Nov. 2, 2015), available at <https://www.managedfunds.org/wp-content/uploads/2015/11/CMC-MFA-Leverage-Ratio-Letter-End-User-Impact-Final.pdf>.

⁵ See FDIC Vice Chairman Thomas M. Hoening, Post-Crisis Risks and Bank Equity Capital, 18th Annual International Banking Conference at the Federal Reserve Bank of Chicago (Nov. 5, 2015), available at <https://www.fdic.gov/news/news/speeches/spnov0515.html>.

day to provide a pre-settlement payment in order to reflect the clearing firm's current exposure at mark-to-market prices. The clearing firm's only remaining exposure arises from any market movement until the next posting of margin – but again, less the value of segregated initial margin posted by the client, which reduces this potential future exposure.

In addition, the clearing firm's guarantee is subject to real-time risk management, which effectively further limits that guarantee in practice. A clearing firm's risk management framework sets and monitors credit limits and position limits to control the overall exposure a clearing firm has to a particular client. Further, in order to permit the clearing firm to quickly remedy a client deficiency (both from an operational and legal perspective), all collateral, including any and all securities entitlements, securities, funds, and other property credited to a client's account, is typically subject to a general lien, continuing first priority security interest, and right of set off and recoupment in favor of the clearing firm to secure any deficit or other amounts at any time owed to the clearing firm and the CCP. Because of this blanket security interest, a clearing firm has all of the rights and remedies available to a secured creditor, which include foreclosure and liquidation of segregated margin to satisfy debts. In sum, from a legal, operational, and practical standpoint, the clearing firm's guarantee is limited and subject to multiple layers of risk management measures.

Accordingly, we believe that the aspects of client segregated margin warrant recognition of its exposure-reducing effect.

II. End-Users Have Experienced Reduced Access to the Risk Mitigation Benefits of Central Clearing

Globally, the Basel Leverage Ratio will move from a disclosure-only requirement to a minimum capital requirement beginning January 1, 2018. On that date, the Enhanced Supplementary Leverage Ratio, which will effectively impose a 5 percent Basel Leverage Ratio requirement on the largest U.S. banking organizations, will also come into effect in the United States.⁶ However, because institutions subject to the Basel Leverage Ratio have been required to disclose their Basel Leverage Ratios as of January 1, 2015, they have begun to operate their businesses as if the Basel Leverage Ratio (and, in the United States, the Enhanced Supplementary Leverage Ratio) were already in effect.

We understand that banking organizations allocate capital to business lines based on their expected returns. That is, such an organization will use its balance sheet to fund businesses that can meet return-on-equity ("ROE") targets given the amount of capital required to be held against the activities of each business. If a capital requirement like the Basel Leverage Ratio requires a greater amount of capital to be held against a low-return business like derivatives clearing than is suggested by the low risk of such business, clearing firms will not be able to meet ROE targets without substantially raising prices. Absent an increase in fees, they will be disincentivized to offer clearing services except as a limited accommodation to clients of other business lines.

Given that prudential and derivatives regulators are trying to assess and quantify the impact of the Basel III changes upon the derivatives markets and users of derivatives, AMG conducted a survey to determine the *current* effect of the Basel Leverage Ratio on AMG members' ability to access cleared derivatives. Twelve members responded to the survey, representing an aggregate of over \$1 trillion in assets under management.

⁶ Banking organizations subject to the enhanced Supplementary Leverage Ratio include the holding companies of most of the largest U.S. clearing firms by market share: Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo.

The survey had the following results:

1. A substantial number of AMG members have been asked by their clearing firm to pay higher clearing fees.

Percentage of Respondents That Have Been Asked to Increase Clearing Fees By Product				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
50%	50%	60%	50%	64%

2. A substantial number of AMG members have been asked by their clearing firm to reroute execution business to it, that is, to use the same clearing firm for trade execution and as their clearing account holder, to avoid larger increases in clearing fees. It is common for AMG members to use one or more clearing firms for execution, and separate clearing firms for the clearing accounts of the entity the AMG member is managing. End users pay separate fees for clearing and for execution of derivatives. Investment advisers acting as fiduciaries have an obligation to obtain “best execution” for clients’ transactions, meaning that the terms for each client transaction generally must be the most favorable terms reasonably available under the circumstances.⁷ As a result, AMG members often must accept higher *clearing* fees for their clients to obtain lower *execution* fees.

Percentage of Respondents That Have Been Asked to Reroute Execution Business to Avoid Larger Increases in Clearing Fees				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
58%	50%	40%	25%	27%

3. AMG members are being asked to agree to a cap (*i.e.*, a limit on their use of derivatives) on outstanding positions.

Percentage of Respondents That Have Been Asked to Agree to a Cap on Outstanding Positions				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
33%	30%	50%	13%	55%

4. Some AMG members have been forced by their clearing firm to terminate clearing relationships (and seek clearing elsewhere, if possible).

Percentage of Respondents That Have Terminated Clearing Relationships Involuntarily				
Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
8%	10%	30%	25%	18%

5. AMG members are being charged higher fees for posting initial margin, particularly when such margin is posted in the form of cash.⁸

⁷ Securities Brokerage and Research Services, Release No. 34-23170 (Apr. 23, 1986); In the Matter of Kidder, Peabody & Co., Inc., et al., Investment Advisers Act Release No. 232 (Oct. 16, 1985); Securities Exchange Act Release No. 12251 (Mar. 24, 1976); Securities Exchange Act Release No. 9598 (May 9, 1972).

⁸ Under U.S. GAAP, cash initial margin posted to a clearing firm is often reflected on the clearing firm’s balance sheet, which adds to the clearing firm’s total leverage exposure under the Basel Leverage Ratio.

Percentage of Respondents That Have Been Charged Increased Fees for Posting Initial Margin					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	42%	40%	40%	13%	27%
Securities	17%	10%	20%	0%	9%

6. AMG members are relinquishing to their clearing firms a greater portion of income from the reinvestment of posted initial margin, particularly for margin posted in the form of cash.⁹

Percentage of Respondents That Have Relinquished to Their Clearing Firms a Greater Portion of Income from the Reinvestment of Posted Initial Margin					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Cash	33%	30%	30%	25%	27%
Securities	8%	10%	10%	0%	9%

7. These impacts have been more pronounced for lower-frequency trading strategies. AMG members typically employ lower-frequency trading strategies, whereas hedge funds and high frequency traders typically employ higher-frequency trading strategies.

Percentage of Respondents That Have Experienced More Significant Impacts Based on Frequency of Trading Strategy					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Lower	33%	40%	30%	25%	27%
Medium	25%	30%	30%	25%	27%
Higher	9%	11%	20%	14%	18%

8. These impacts have also been more pronounced for directional trading strategies. “Directional” means that individual trades with the clearing firm tend to take a market position and tend not to be offsetting under a netting agreement. AMG members tend to use directional strategies because their clients use derivatives to further an investment strategy or hedge investment risks.

Percentage of Respondents That Have Experienced More Significant Impacts Based on Directional or Market Neutral Trading Strategies					
	Futures	Options	Interest Rate Swaps	FX Swaps	Credit Swaps
Directional	33%	50%	40%	29%	27%
Market Neutral	9%	10%	20%	13%	18%

III. Conclusion

The AMG survey results show that the Basel Leverage Ratio’s failure to recognize the exposure-reducing effect of segregated margin is already having a negative impact on AMG members’ ability to hedge risks and reduce volatility. We are greatly concerned that this effect will only be magnified as the Basel Leverage Ratio becomes a binding minimum requirement.

⁹ For a discussion of the legal restrictions on reinvestment of initial margin, see part I of this letter above.

Basel Committee on Banking Supervision
February 1, 2016

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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 Tim Cameron at (202) 962-7447 or tcameron@sifma.org or Laura Martin at (212) 313-1176 or lmartin@sifma.org.

Respectfully submitted,



Timothy W. Cameron, Esq.
Managing Director
Asset Management Group – Head
Securities Industry and Financial Markets Association



Laura Martin
Managing Director and Associate General
Counsel
Asset Management Group
Securities Industry and Financial Markets
Association