

**EFAMA'S REPLY TO THE BASEL COMMITTEE ON BANKING SUPERVISION
CONSULTATIVE DOCUMENT ON REVISIONS TO LEVERAGE RATIO
DISCLOSURE REQUIREMENTS**

EFAMA welcomes the opportunity given by the Basel Committee on Banking Supervision Consultative Document on Leverage ratio treatment of client cleared derivatives.

Promotion of central clearing of standardised derivative contracts to mitigating systemic risk and make derivatives markets safer is one of the primary objectives of BCBS post crisis reforms.

EFAMA supports objectives to mitigate risks and make derivatives market safer. However, EFAMA would like to use the opportunity presented by this consultation to draw attention to fund managers experience of difficulties in obtaining access to clearing and the costs this incurs that must be supported and reduces the benefits to use central clearing.

With respect to costs of clearing, the current leverage ratio methodology is particularly penalizing end users that are posting margins in order to protect Clearing Member and the CCP from their own default.

This is particularly the case for fund managers that tend to have very directional derivatives portfolios, used mainly for hedging but also to gain market exposures. Having directional exposure involve porting large amounts of initial margins when compared to the notional of transactions.

Incidentally, the more margins are posted to protect against risk of default the worse it is for clearing members that are acting as an intermediary in terms of capital requirement. I.e. the more a client protects others against its own default the more he has to pay for it. This effect is counterproductive and goes against regulators objectives of providing incentives to clearing.

1- Is there concrete and robust empirical evidence that would warrant a revision to the leverage ratio treatment of client cleared derivatives?

Yes, we principally believe that a revision of the treatment of the leverage ratio of client cleared derivatives is necessary.

BCBS, CPMI, FSB and IOSCO consultative document on incentives to centrally clear over the counter (OTC) derivatives has evidenced that costs, access capacity and margin type (such as cash collateral requirements) are strong disincentives to clearing. Overall, the picture is mixed for end clients. This is highlighted in the report by the fact that use of voluntary clearing remains limited.

The European clearing model is a principal to principal model where the Clearing Member is intermediating the relationship between end user and CCP.

The industry has made efforts over the last number of years to develop alternative solutions such as direct clearing membership models that would reduce to some extent the reliance on Clearing Member participation within the clearing framework.

Industry efforts such as direct clearing membership model developed so far still present many uncertainties:

- In terms of economic exposure for end users: CCP exposure within recovery or resolution process, specific capital requirements, effective operational costs;
- In terms of capital treatment for the banks: Although banks would only be intermediating limited part of client clearing activity, capital treatment remains unclear and has halted developments.

In addition, access to new clearing models are not necessarily granted by clearing members to end users (clearing members may not have capacity to bear develop costs for all models and/or may not be willing to develop some models due to uncertainties related to regulatory treatment).

BCBS, CPMI, FSB and IOSCO consultative document in incentives to centrally clear over the counter (OTC) derivatives has also evidenced that for less active end clients in derivatives usage, incentives to clear are mixed and may not be enough to compensate operational complexity and costs introduced by central clearing.

Beyond cost, effective capacity to clear depends on willingness of clearing members to develop their activity, which has turned out to be a real challenge for less active clients for several reasons:

- Leverage ratio has concentrated client clearing services in a relatively small number of banks (which could raise concern during periods of stress);
- Transactions depend on clearing limits and capacity granted by clearing members. Allocating clearing limit is equivalent to allocating balance sheet size to their clients;
- For directional portfolios, clearing members may be willing to restrict credit lines granted to end clients, as the result of balance sheet costs imposed by the leverage ratio.

2- To what extent would the two potential revisions discussed in this consultative document adequately meet the G20 Leaders' policy objectives of strengthening the resilience of the banking system by preventing excessive leverage and promoting central clearing of standardised derivative contracts?

The two potential revisions discussed in this consultative document would be an effective action to promote central clearing of standardised derivative contracts as current methodology is penalizing banks, i.e. ultimately end users for the margins posted to protect banks and CCPs against end users' default.

It should be recognized that when a clearing member is acting as a pass through of the CCP, i.e. collecting margins from the client for the sole purpose of posting them back to the CCP without collateral transformation, this activity should retain limited capital requirement. Indeed, in such circumstances, the bank only purpose is to act as intermediary between the CCP and end users and not to act for its own account or on its own behalf.

In addition, margins called by CCPs are calibrated to allow for a very high regulatory confidence interval on mark to market move to allow the Clearing Member and/or CCP dispose of the portfolio in case of client default. Residual risks, if any and where relevant, could attract capital requirements but principal risk already covered by collateral transferred from client to the CCP should not attract any capital requirement.

EFAMA members are not willing to comment on detailed methodology that should be used to measure capital requirement. However, they consider that, if clearing member is passing through margins from them to the CCPs through segregated accounts, this should not attract capital requirements as margins collected and posted are not collected for their own benefit but for managing counterparty risk exposures as per CCP and client requirements.

3- What are the potential forward-looking behavioural dynamics of the client clearing industry that could occur as a result of possible changes to the leverage ratio treatment of client cleared derivatives?

Realigning banks capital requirements with effective risk profile of their activity, i.e. recognising clients and CCPs offsetting margins, should allow for a price reduction of clearing. This should act as an incentive to clear for end users that are comparing the costs of cleared transactions versus bilateral trades.

To the extent capital is not called on banks when they are directly onward posting margins, they receive to the CCP, this should provide them with:

- A strong incentive to act as a pass through to the CCP and avoid the need for collateral transformations;
- An incentive to calibrate clearing prices in line with their effective economic and operational activity and costs to remain competitive.

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