

31 March 2014

European Commission
Directorate-General for the Internal Markets and Services
Unit H1 Banking and Financial Institutions
Mr Erik van der Plaats
Rue de Spa 2
1049 Brussels
Belgium

Written submissions as a follow-up to the Public Hearing of 10 March 2014 on the Leverage Ratio

Dear Mr. Van Der Plaats,

This letter contains the response of the Association for Financial Markets in Europe ("AFME") and the International Swaps and Derivatives Association, Inc. ("ISDA") to the European Commission's request for written contributions in relation to the delegated act on European implementation of the Leverage Ratio.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. For more information, visit: www.afme.eu.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Association for Financial Markets in Europe

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The accompanying response mainly refers to a global FAQ process and a wider industry submission to the BCBS regarding the final BCBS Leverage Ratio (LR) rules. The FAQ submission is a result of a thorough industry consultation process involving a wide range of industry representatives across the world. It is reflective of the industry consensus on this topic and aims at being as constructive as possible in seeking a proportionate outcome. These FAQs have also been sent to the European Commission.

We are very keen to obtain clarification on these points to ensure that they can be taken appropriate account of in the Commission's Delegated Act on the Leverage Ratio to avoid regional divergence and inconsistent implementation.

We appreciate the opportunity given to us to convey our messages. We stand ready to offer comments on more technical issues that the Commission may want to pursue after considering our high-level comments. We look forward to meeting you in due course and to continuing a constructive dialogue on these important issues.

Yours sincerely,



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Consultation response

Written submissions as a follow-up to the Public Hearing of 10 March 2014 on the Leverage Ratio

31 March 2014

Introduction

AFME and ISDA (“the industry”) welcome the opportunity to submit a written response to the above public hearing. We highlight below the overarching issues, followed by answers to individual questions the Commission has raised.

The industry is generally supportive of the Commission’s aims to impose a leverage ratio as a supplementary backstop to the risk-based measure and in this regard support transposing changes introduced in the BCBS 270 into the exposure measure in the CRR leverage ratio. However, as we highlight, there are a number of material interpretation issues in the final text of the Basel leverage rules that need to be resolved before the rules can be transposed at a national and regional level.

AFME and ISDA are working actively with our members to identify these issues in a comprehensive way. In this context, AFME, together with its global umbrella organization GFMA, along with ISDA, IIF and a number of other Associations have initiated a FAQ process seeking these clarifications from the BCBS. We believe that this is important in order to ensure that the rules are interpreted correctly without unintentional adverse impacts on the markets and to facilitate consistent implementation. The industry recommends that the timeline for this delegated act is extended in order to incorporate the key elements of the Basel text and the requested clarifications in the Level 1 text rather than rely on Level 2 technical standards and increase EBA’s workload. As a minimum the EC should move forward with incorporating the changes into the CRR in a way that allows competent authorities to take account of clarifications by the BCBS, as and when they become available.

Please see the appendix for the communication on the final Basel leverage ratio framework which has been sent to the BCBS. This takes the form of FAQs addressing various aspects of the proposals that have been raised with the Associations over the past two months and seeks clarification of a number of material interpretation issues in the new rules. In addition, there are a few further issues that we are working on and are likely to submit to Basel in due course.

The next section summarises the FAQs in response to the Commission’s specific questions and points to the relevant sections of the FAQ paper for more detailed comments. We also note additional points that should be clarified before the rules are transposed to the CRR.

Commission's Questions

1. The criteria for netting of SFT cash receivables and payables with the same counterparty?

The industry wishes to ensure that internationally uniform measures are applied to similar economic exposures. Accordingly, we emphasise the importance of taking appropriate account of how the interpretation of the SFT netting rules in the Basel proposal may produce different results according to the way in which SFT markets operate in different jurisdictions. This is necessary in order to avoid unintended consequences in the European markets.

In this respect annexes 2 and 3, put together by the French Banking Federation, highlight some of the differences between markets as well as specificities in Europe that may, in case the rules are interpreted incorrectly and without this context, lead to higher exposure measures than what the real economic exposure is.

In order to avoid any unintended consequences, we propose in the joint industry FAQs (attached as annex 1) a number of interpretations relating to articles 33 (i) (a-c) and 37 (and footnote 25) in the Basel rules. In summary, the industry believes that despite material differences in market practices and venues where SFT transactions are traded (for example open maturity vs. overnight, tri-party vs. bilateral, different settlement practices), similar economic exposures should be treated equivalently in the exposure measure.

Furthermore, we are concerned that **forward-starting SFT transactions** may be viewed as "forward asset purchases" and thus included in the exposure measure at the full amount before the settlement date. This treatment, however, would result in a double-counting of the exposure of the related transactions that are already on the balance sheet; though the two exposures will never be on the balance sheet at the same time.

To roll existing financing, banks often enter into forward-starting repo-style transactions to settle on the day on which active outstanding trades will mature. For instance, in Europe, the typical settlement cycle for repo activity is T+1 to T+3. For the period that the transactions are pending settlement, they are typically off-balance sheet. The unintended consequence of including these transactions is that firms are incentivized to reduce booking transactions in advance, and would instead convert to same day trading with a direct increase in settlement risk, especially when transactions are across different time zones.

Please refer to the FAQs in the appendix, inclusive of further technical detail, for a full list of these interpretation issues.

In addition to the globally agreed FAQs that have already been submitted to the BCBS and to the Commission, AFME, ISDA and our members highlight that there is an additional interpretation issue that has been raised after the FAQs were submitted. This relates to the rules appertaining to the **SFT qualifying collateral in the RWA framework** and whether these rules should be transposed into the LR measure. The industry believes that it would be inappropriate to take account of the qualifying status for the purposes of calculating the exposure measure in the LR.

We emphasise that this is an issue which should be addressed at the Basel level in the same way as the other questions of interpretation that have already been submitted to the BCBS. This issue will be added to the next set of FAQs that the industry is going to send to the BCBS and therefore we would kindly ask the Commission to also consider this additional point in its delegated act.

When calculating the counterparty risk exposure measure on a reverse repo for RWA purposes, under the financial collateral comprehensive method, consideration has to be given as to whether collateral is “qualifying” or not. For example, sub-investment grade corporate bond collateral is not eligible as collateral in the banking book.

Please confirm that for leverage purposes all collateral may be taken into account to calculate the add-on exposure measure described in para 33(ii), regardless of its qualifying status for counterparty risk capital purposes. The impact of disallowing certain collateral for leverage purposes is that the leverage exposure measure for a financing secured on collateral which happens to be ineligible for RWA purposes will be twice the exposure measure for a much riskier unsecured loan.

This is because if the leverage exposure measure for a repo with a client, which the bank is financing, is the IFRS balance sheet exposure (cash out) plus a MTM add-on for counterparty risk (cash out less securities in), the second part of the formula would exclude securities in and therefore lead into double count of the cash outflow. The industry wants to ensure that there is no read-across from the counterparty risk rules in order to avoid such duplications with severe consequences to the liquidity of lower grade securities.

2. The criteria for allowing cash variation margins received to be deducted from the derivative exposure value?

The industry has made a number of recommendations for interpreting the Basel text regarding paragraph 25 (from point i to point v) and footnote 12 to ensure that the interpretations are globally consistent, take into account risks that may arise from incorrect interpretation and to ensure that the rules are consistent with market best practices (for example currency criteria for cash variation margin netting, which should be in line with the master agreement governing the related transactions) to avoid anomalous outcomes.

Please refer to the appendix for a full list of recommended interpretations and reasoning why the industry believes that these issues need to be clarified before the Basel rules are transposed.

3. The criteria for allowing the notional amount of written CDS to be reduced with the protection recognition?

Please see the appendix regarding article 30 in the BCBS 270 in relation to the scope of the credit derivatives rules. **We believe that paragraph 30 should apply exclusively to credit default swaps (CDSs, including credit linked notes which the Basel framework view as cash collateralised CDSs) and total return swaps to keep the LR consistent with the calculation of the credit risk component under the standardized approach under the Basel II framework.**

European implementation – Solo regulated entities

We note that in Europe, many banks need to comply with the leverage measure on a solo basis rather than as part of the consolidated group. This clearly puts pressure on entities with significant intra-group activity, including broker dealers that typically manage the banks' access to wholesale markets, provide risk management services to the core bank's client base and have substantial repo and other market making activities in support of European capital markets.

The main intra-group exposures concerned are:

- internal refinancing operations between the parent company and its affiliates;
- derivatives operations between the group's investment bank and other entities of the group: this way of operating is reinforced by the EMIR Regulation; and
- financial guarantees

Therefore, to avoid potential unintended consequences, for example to the ability of these entities to support the group's internal treasury and risk management, client derivatives businesses and market making capabilities, the industry believes that intra-group transactions should be excluded from the exposure measures of solo regulated entities that are part of an equivalently supervised consolidated group

This request is based on similar treatments in the capital and large exposure frameworks.

For the capital adequacy ratio, art 113.6 of the CRR exempts rightfully intra-group exposures if certain strict conditions are met, among which:

- Transactions between two entities belonging to the same group;
- Counterparties established in the same Member State; and
- Counterparty included in the same consolidation on a full basis.

For the large exposure framework, art 400(2)(c) allows competent authorities to fully or partially exempt intra-group exposures from the large exposure limits, provided the solo-entity and its related counterparties are part of a group that is covered by equivalent supervision on a consolidated basis.

The delegated act on leverage ratio should therefore similarly allow solo regulated entities to benefit from the exemption of intra-group exposures, provided that the solo-entity and its associated intra-group counterparties are part of an equivalently supervised fully-consolidated group. At minimum, the same rules granted for the purposes of the capital adequacy ratio calculations (i.e. Art 113.6) should be applied to the leverage ratio exposure measure.

Additionally, the industry wishes to highlight that if intra-group transaction were to be included, it would imply that capital needs to be allocated to every tier of consolidation to cover for intra-group exposures. This would eventually lead to a leverage ratio far in excess of the 3% minimum requirement at the highest level of consolidation, depending on how many solo regulated subsidiaries are within the group and how much intra-group activity was undertaken. Clearly, groups that have many solo regulated subsidiaries would be disadvantaged over those that have a more consolidated legal structure.

Annex 1: Technical Recommendations – January 2014 BCBS Leverage Ratio

General comment: We recognize that the BCBS framework is intended to create a common standard for all global banking organizations, and accordingly, where there are gray areas regarding how the finalized language should be interpreted, technical guidance should be issued to ensure consistent international implementation.

Para. Ref.	Final BCBS Leverage Ratio Text	BCBS Recommendation
25(i)	For trades not cleared through a qualifying central counterparty (QCCP) the cash received by the recipient counterparty is not segregated.	<u>Recommended Interpretation:</u> Institutions may not know whether a posting counterparty has actually segregated the cash received. Therefore, the Basel Committee should clarify that posting parties may assume that the counterparty has not segregated the cash received unless required to do so pursuant to applicable legal requirements or contractual terms.
25(ii)	Variation margin is calculated and exchanged on a daily basis based on mark-to-market valuation of derivatives positions.	<u>Recommended Interpretation:</u> There are certain categories of derivatives transactions where variation margin is exchanged on a regular basis, but not necessarily daily. Options CCPs and energy CCPs are examples in the cleared space where variation margin is not necessarily exchanged on a daily basis. Buyers of exchange-traded options do not receive VM from the options CCP who holds the margin collected from option sellers during the course of the contract. Energy CCPs typically settle variation margin less frequently than daily. We encourage banking regulators to implement the daily variation margin on a principle basis, recognizing that the key element is the exchange of variation margin payments on the shortest feasible cycle, rather than on a daily basis in all cases. We believe such an approach would be consistent with the BCBS margin framework, which refers to the variation margin payments as being required on “a regular (e.g., daily)” basis, as well as the U.S. banking agencies’ proposed rules for variation margin requirements, which recognize flexibility of up to one week for some variation margin categories. See 76 Fed. Reg. 27,564, 27,589 (May 11, 2011) (proposed rule §.__ 4(b); BCBS Margin Framework Requirement 2.1.

<p>25(iii)</p>	<p>The cash variation margin is received in the same currency as the currency of settlement of the derivative contract.</p>	<p><u>Recommended Interpretation:</u> The BCBS leverage framework refers to the “currency of settlement,” a concept which may result in confusion when applied to financial markets practice. For the reasons set forth below, we request clarification that any variation margin payments received by the banking organization should only be recognized as exposure-reducing when the payments are made in the currency or currencies identified in the collateral agreement, for example the Credit Support Annex (CSA) to the Master Netting Agreement (MNA).</p> <p>There are three distinct concepts that the Basel Committee should distinguish between when implementing these rules. First, a banking organization may execute numerous derivatives with a counterparty, all of which are governed by the same MNA. In some cases, these derivatives may provide for different currencies of settlement of contractual payments. The purpose of an MNA is to provide for a single netting structure to cover all of these positions with cash flows in different currencies. The net amount, determined utilizing a spot FX conversion and expressed in a single currency, forms the basis for margin calls as well as the net settlement upon a termination of the MNA.</p> <p>Second, a banking organization may be required under an MNA to make a single margin payment on a daily basis with respect to the net variation margin amount owed for all of the positions covered by the MNA, after completion of the netting process described above. This single net margin payment will be made in the currency or currencies identified in the CSA (or relevant collateral agreement) to the MNA. We believe that the reference in the BCBS leverage framework to “currency of settlement” logically applies at this step, so that, as described above, any variation margin payments received by the banking organization should only be recognized as exposure-reducing when the payments are made in the currency or currencies identified in the CSA to the MNA.</p>
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		<p>Finally, there is the currency (or currencies) in which the cash flows of individual derivative transactions naturally occur, which may be different from both the close-out currency of the MNA and the CSA currency(ies).</p> <p>By way of illustration, consider a banking organization that has 100 derivatives positions with a counterparty, all of which are governed by the same MNA. The 100 derivatives positions include contracts with cash flows in four major currencies (e.g., USD, EUR, JPY and GBP). On a daily basis, the banking organization determines the mark-to-market position of each of the 100 derivatives positions and determines a net amount owed to (or by) the bank as variation margin. The CSA between the parties identifies the currencies for payment of variation margin (e.g., USD or EUR). In this case, any variation margin payments received by the bank in USD or EUR will reduce the exposure of the bank, even though some of the underlying positions have cash flows in other currencies (e.g., JPY and GBP).</p> <p>As the example illustrates, if the same-currency criterion is applied on a narrow basis, inconsistencies would arise in the net exposure / net replacement cost (RC) calculation. Banks calculate the net mark-to-market (MTM) across currencies by converting multiple currencies at spot FX rates into a single net amount, for a given MNA. MNAs necessarily rely on the principle that a single variation margin payment can be applied against multiple positions with cash flows in various currencies, with the positions owed in each currency determined in accordance with spot FX rates.</p> <p>Applying the same-currency criterion narrowly would result in anomalous outcomes. If the same-currency requirement were applied at the first step described above, margin payments that would be recognized as an offset to the derivative exposure under relevant accounting and regulatory regimes would not reduce a banking</p>
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		<p>organization's leverage exposure and would be inconsistent with market practices.</p> <p>In addition this would incentivize banks to bilaterally exchange variation margin in different currencies, to fulfill the currency matching criteria in a narrow interpretation. A bilateral exchange of VM in different currencies will, however, significantly increase the cross-currency settlement risk resulting from timing differences between the posting and the receipt of cash VM (Herstatt risk). Currently the market practice is to make a single net cash VM payment in an agreed transport currency. Incentivizing banks to make individual VM currency flows go out at potentially different times introduces significant intraday settlement risk if its counterparty defaults between cash-flows, see example 4 in the appendix.</p> <p>To the extent FX risk arises due to differences between the currency of VM received and the other contract settlement currencies, it is quite small, given it is limited to short-term timing differences (e.g., if FX rates move one day, additional collateral will be called the next day). Such timing differences are risk managed to a minimum through requirements for frequency of margin transfer, low thresholds for transfer, low minimum transfer amounts and initial margin.</p> <p>In fact, we are concerned that to apply the same currency criterion narrowly, as either transaction currency or MNA settlement currency, would be FX risk increasing given the current market practice for counterparties to enter into a CSA depends on the counterparties' access to specific currencies. A requirement to post variation margin, which serves as a form of pre-settlement payment, in either the MNA settlement currency or transaction settlement currency of the derivative, could create issues for foreign branches of internationally active banks that generally have more limited central bank access: this new structure</p>
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		<p>of CSA would create multiple currency funding risks due to the potential inability to access multiple currencies in times of stress and hence counterparties would be reluctant to sign such CSAs.</p> <p>The four examples at the end of this document illustrate the real world problems of applying the same-currency criterion on a narrower basis.</p>
25(iv)	Variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to the threshold and minimum transfer amounts applicable to the counterparty.	<p><u>Recommended Interpretation:</u> We understand the intent of this clause to be satisfied if the contractual terms of the margining agreement require that the variation margin exchanged is the full amount of the current exposure (or current MTM) beyond threshold and minimum transfer amounts. This interpretation would prevent short term timing differences that result in small, temporary differences between VM and MTM—e.g., in the common case where a morning margin call is based on the MTM of the previous business day—from disallowing the recognition of legally enforceable cash variation margin already exchanged, and thus introducing misleading volatility in a bank’s exposure measure.</p>
25(v)	Derivatives transactions and variation margins are covered by a single master netting agreement (MNA) ^{9/10} between the legal entities that are the counterparties in the derivatives transaction. The MNA must explicitly stipulate that the counterparties agree to settle net any payment obligations covered by such a netting agreement, taking into account any variation margin received or provided if a credit event occurs involving either counterparty. The MNA must be legally enforceable and effective in all relevant jurisdictions, including in the event of default and bankruptcy or insolvency.	<p><u>Recommended Interpretation:</u> The Basel Committee should implement the MNA requirement in a manner consistent with legal and market practice. For example, the reference in the BCBS framework to an MNA being “legally enforceable and effective in all relevant jurisdictions” is potentially unworkable under certain local regulations, as standard legal opinions may not offer comfort on legal effectiveness. We recommend that this requirement be consistent with other paragraphs of the Basel framework relating to legal certainty, for example paragraph 118, where the requirement is “legally enforceable in all relevant jurisdictions.”</p>
Foot. 12	For the purposes of paragraphs 27 and 28, “trade exposures” includes initial margin irrespective of whether or not it is posted in a manner that makes it remote from the insolvency of the CCP.	<p><u>Recommended Interpretation:</u> We believe that the BCBS leverage framework is potentially unclear in its application to cash initial margin received from clients that a banking organization may not post to the CCP or QCCP, but would hold in segregation. For example, such a case may arise when a banking organization receives more cash collateral from a client than is required to post to the CCP or QCCP. This occurs for</p>

		<p>prudent risk management purposes where the bank determines it would require a higher margin amount for that particular credit than the CCP or QCCP requires. If this cash were not excluded from the leverage exposure measure, then the banking organization would be disincentivized from requesting this excess collateral, which is economically risk reducing. We believe that the Basel Committee should clarify that segregated cash initial margin amounts are to be excluded from the leverage ratio. We believe this is the correct outcome from a policy perspective. We further note that this treatment would be consistent with the Prudential Regulation Authority of the Bank of England Supervisory Statement SS3/13 issued in November 2013, which stated:</p> <p style="padding-left: 40px;">“In relation to derivative trades undertaken by the firm to facilitate customer central clearing through qualifying central counterparties (QCCPs), the exposure measure may be adjusted in the following ways:</p> <p style="padding-left: 80px;">a. initial margin received in cash from the client, provided it is segregated from the firm’s own cash, does not have to be recognized.”</p>
<p>30</p>	<p>In order to capture the credit exposure to the underlying reference entity, in addition to the above CCR treatment for derivatives and related collateral, the effective notional amount referenced by a written credit derivative is to be included in the exposure measure. The effective notional amount of a written credit derivative may be reduced by any negative change in fair value amount that has been incorporated into the calculation of Tier 1 capital with respect to the written credit derivative. The resulting amount may be further reduced by the effective notional amount of a purchased credit derivative on the same reference name, provided:</p> <ul style="list-style-type: none"> • the credit protection purchased is on a reference obligation which ranks pari passu with or is junior to the underlying reference obligation of the written credit derivative in the case of single name credit derivatives;16 and • the remaining maturity of the credit protection purchased is equal 	<p><u>Recommended Interpretation:</u> We request a clarification that the language of paragraph 30 applies exclusively to written credit default swaps and total return swaps. Such an interpretation would be consistent with the calculation of credit risk under the Standardized Approach under the Basel II capital framework. See Basel Committee on Banking Supervision, <i>International Convergence of Capital Measurement and Capital Standards</i>, at 48, ¶ 193 (June 2006).</p>

	to or greater than the remaining maturity of the written credit derivative.	
33(i)(a)	Transactions have the same explicit final settlement date.	<u>Recommended Interpretation:</u> Securities Financing Transactions do not always have an explicit final settlement date, as some of them are undated. This is the case of open or evergreen repos, which are market practice in certain countries. In these cases, the transactions can be unwound unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day. We believe that these transactions should be treated as if they had a one-day maturity and that the requirement that they have the “same explicit final settlement date” should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The BCBS leverage framework would otherwise result in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos).
33(i)(b)	The right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both currently in the normal course of business and in the event of (i) default; (ii) insolvency; and (iii) bankruptcy	<u>Recommended Interpretation:</u> It is unclear whether Par. 33 (i) (b) refers to the default, insolvency and bankruptcy of the counterparty or also of the reporting entity. Given that the framework means to capture the risk exposure / leverage of the reporting entity, and since market practices differ (i.e. not all SFT contracts include stipulations referring to the events of default of both counterparty and reporting entity), we believe par. 33 (i) (b) should solely consider the circumstances of the counterparty. We take the view that each party in the agreement should only seek a legal opinion covering the default of its counterparty.
33(i)(c)	To achieve such equivalence, both transactions are settled through the same settlement system and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day <u>and the linkages to collateral flows do not result in the unwinding of net cash settlement.</u> ²²	<u>Recommended Interpretation:</u> The BCBS leverage framework refers to “linkages to collateral flows [that] do not result in the unwinding of net cash settlement.” We believe that this condition is intended to address that securities and cash should be settled on the same settlement system, which would be satisfied for most tri-party and bilateral SFTs with either CCP or DVP settlement, though not cross currency repo (for example, hard currency exchange offshore, securities onshore would

	<p>²²<u>This latter condition ensures that any issues arising from the securities leg of the SFTs do not interfere with the completion of the net settlement of the cash receivables and payables.</u></p>	<p>therefore not be eligible) .</p>
<p>37 and footnote 25</p>	<p>A bank acting as agent in an SFT and providing an indemnity or guarantee to a customer or counterparty will be considered eligible for the exceptional treatment set out in paragraph 36 <i>only</i> if the bank’s exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent and the value of the collateral the borrower has provided. In situations where the bank is further economically exposed (ie beyond the guarantee for the difference) to the underlying security or cash in the transaction,²⁵ a further exposure equal to the full amount of the security or cash must be included in the exposure measure</p> <p>²⁵ For example, due to the bank managing collateral received in the bank’s name or on its own account rather than on the customer’s or borrower’s account (eg by on-lending or managing unsegregated collateral, cash or securities).</p>	<p><u>Recommended interpretation:</u> It is standard practice for agent lenders to use omnibus accounts to hold segregated client collateral. This is designed to improve operational efficiencies and reduce costs and ensures no commingling of client assets with bank assets. We therefore believe that the prohibition on the ability of agent lenders to manage unsegregated collateral, cash or securities is not intended to preclude the use of such omnibus accounts, provided that client collateral is properly segregated from the bank’s proprietary assets.</p> <p>It is common for agent lenders to provide an indemnification for the repurchase leg of certain securities lending transactions. The repurchase leg is used as a means of reinvesting cash collateral received from the borrower and generally involves a separate counterparty default indemnification provision. Consistent with risk-based capital standards, we believe that the repurchase leg of a securities lending transaction should be viewed as a separate transaction, and as such, both the securities lending transaction and the repurchase agreement would qualify as separate transactions, each individually eligible for the treatment described in subparagraph (ii) of paragraph 33.</p>
<p>Table 1 Line item 2</p>	<p>Adjustment for investments in banking, financial, insurance or commercial entities that are consolidated for accounting purposes but outside the scope of regulatory consolidation</p>	<p><u>Recommended interpretation:</u> Even though this line item solely refers to entities that are consolidated for accounting purposes, we propose to also include in this line item associates that are included on the basis of proportionate consolidation but which are outside the scope of regulatory consolidation.</p>
<p>Annex par. 17 as related to par.38-39</p>	<p>Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown, will receive a CCF of 100%</p>	<p><u>Recommended interpretation:</u> Under the BCBS final rules, “forward asset purchases” are treated as an “off-balance sheet” item and included in the exposure measure at a 100% CCF. Separately, SFTs are included in the exposure measure based on the asset amount recognized for accounting purposes (with netting adjustments allowed if certain</p>

		<p>conditions are met) plus the counterparty credit risk add-on.</p> <p>The question arises as to what the correct treatment is for forward starting repo-style transactions. Forward starting repo-style transactions are traded with a forward-starting date. To roll existing financing, banks often enter into forward-starting repo-style transactions to settle on the day on which active outstanding trades will mature. For instance, in Europe, the typical settlement cycle for repo activity is T+1 to T+3. For the period that the transactions are pending settlement, they are typically off-balance sheet. On the settlement date, however, the full notional amount would be on-balance sheet. In other words, forward-starting repo-style transactions will only move onto the balance sheet to replace existing on-balance sheet repos when the latter roll-off.</p> <p>We are concerned that forward-starting repo-style transactions may be viewed as “forward asset purchases” and thus included in the exposure measure at the full amount before the settlement date. This treatment, however, would result in a double-counting of the exposure of the related transactions that are already on the balance sheet; though the two exposures will never be on balance sheet at the same time. The unintended consequence of including these transactions is that firms are incentivized to reduce booking transactions in advance, and would instead convert to same day trading with a direct increase in settlement risk, especially when transactions are across different time zones.</p> <p>We would appreciate BCBS’s clarification that such replacement transactions are not included, or, if it is the intention to include them, that such forward starting repo-style transactions should be treated as securities financing transactions and not as off-balance sheet items.</p> <p>In addition, we would like to clarify that “forward asset purchases” is not intended to capture deliverable bond futures. Bond futures are frequently used to hedge trade exposures and are considered as some of the most liquid products and are central to the liquidity of government bond markets in Europe. They are typically rolled over approaching maturity. For accounting purposes, bond futures are treated as derivatives in the trading book; therefore we assume they would be</p>
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		<p>treated as derivatives in the leverage exposure measure and not off-balance sheet items.</p> <p>In a similar vein, we believe that OTC equity forward purchases in the trading book will already be captured under the derivative exposure measure.</p> <p>Similarly, we believe that forward forward deposits placed, while certainly creating new credit risk (or extending the maturity of existing credit risk) on the counterparty with whom the institution is committed to place the cash, do not necessarily increase leverage: they are more likely to reflect a desire to roll over an existing deposit asset which is already included in the leverage exposure measure. The inclusion of the forward forward deposits is therefore likely to result in double counting an asset in the leverage calculation. We would suggest that forward forward deposits which represent the renewal of an existing deposit on its maturity (whether with an existing counterparty or a new counterparty) should be excluded from the exposure measure.</p>
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Example 1:

Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. “MNA settlement currency” is USD.

All values (regardless of currency are shown in USD equivalent values)

USD MTM = +300

YEN MTM = -100

Net MTM = +200

If uncollateralized, exposure = 200

If currency of settlement = CSA permitted currency

Case 1a = client posts 200 EUR – Leverage exposure would be 0

Case 1b = client posts 200 USD – Leverage exposure would be 0

If currency of settlement = “MNA settlement currency”

Case 2a = client posts 200 EUR – Leverage exposure would be 200

Case 2b = client posts 200 USD – Leverage exposure would be 0

If currency of settlement = Transaction currency

Case 3a = client posts 200 EUR – Leverage exposure would be 200

Case 3b = client posts 200 USD – Leverage exposure would be 0

Example 2:

Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. “MNA settlement currency” is USD. All values (regardless of currency are shown in USD equivalent values)

USD MTM = +300

YEN MTM = +100

Net MTM = +400

If uncollateralized, exposure = 400

If currency of settlement = CSA permitted currency

Case 1a = client posts 400 EUR – Leverage exposure would be 0

Case 1b = client posts 400 USD – Leverage exposure would be 0

Case 1c = client posts 300 USD and 100 EUR – Leverage exposure would be 0

If currency of settlement = “MNA settlement currency”

Case 2a = client posts 400 EUR – Leverage exposure would be 400

Case 2b = client posts 400 USD – Leverage exposure would be 0

Case 2c = client posts 300 USD and 100 EUR – Leverage exposure would be 100

If currency of settlement = Transaction currency

Case 3a = client posts 400 EUR – Leverage exposure would be 400

Case 3b = client posts 400 USD – Leverage exposure would be 100

Case 3c = client posts 300 USD and 100 EUR – Leverage exposure would be 100

Example 3

Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. “MNA settlement currency” is USD. All values (regardless of currency are shown in USD equivalent values)

USD / EUR Cross Currency Swap MTM = +400

Net MTM = +400

If uncollateralized, exposure = 400

If currency of settlement = CSA permitted currency

Case 1a = client posts 400 EUR – Leverage exposure would be 0

Case 1b = client posts 400 USD – Leverage exposure would be 0

If currency of settlement = “MNA settlement currency”

Case 2a = client posts 400 EUR – Leverage exposure would be 400

Case 2b = client posts 400 USD – Leverage exposure would be 0

If currency of settlement = Transaction currency (both currencies of swap)

Case 3a = client posts 400 EUR – Leverage exposure would be 0

Case 3b = client posts 400 USD – Leverage exposure would be 0

If currency of settlement = N/A, as there is no single settlement currency of the swap (that involves EUR / USD cash flows)

Case 4a = client posts 400 EUR – Leverage exposure would be 400

Case 4b = client posts 400 USD – Leverage exposure would be 400

Example 4

A further example to illustrate the complexity of applying a narrow application based on transaction currency (in which the exposure is reduced only if the VM currency = derivative transaction currency)

(All values shown in USD equivalent; the currency sign indicates the currency of the USD equivalent values)

USD MTM = +100

EUR MTM = +50

GBP MTM = -80

If uncollateralized, exposure = 70

- There are potentially three approaches to allocate this MTM asset to the related derivative transaction currencies:
 - i) Assume first allocate to \$ -> \$70
 - ii) Assume first allocate to € then to \$ -> €50 + \$20
 - iii) Proportionally to gross asset-> $(\$100/150)*70 + (€50/150)*70 = \$(2/3)*70 + €(1/3)*70$
- If client posts 70 in USD, under the corresponding approaches
 - i) leverage exposure would be $\$70 - \$70 = 0$
 - ii) leverage exposure would be $€50 + \max(0, [\$20 - \$70]) = €50$

iii) leverage exposure would be $\max\{0, [\$((2/3)*70) - \$70]\} + \text{€}(1/3)*70 = \text{€}(1/3)*70$

- If client posts 70 in EUR, under the corresponding approaches

i) leverage exposure would be \$70 (not allowed to net)

ii) leverage exposure would be $\$20 + \max(0, [\text{€}50 - \text{€}70]) = \20

iii) leverage exposure would be $\max\{0, [€((1/3)*70) - €70]\} + \$(2/3)*70 = \$(2/3)*70$

If client posts in USD one would prefer to adopt approach (i). Otherwise if client posts in EUR one would opt approach ii) and so on. Further, as more currencies are involved in the MNA, the possible approaches can be further complicated and the permutation of possible scenarios would increase substantially. Given the potential complexity on how the netting logic would be applied, banks will make their own interpretations, creating potentially large differences in the implementation across banks. This would seem to be contrary to the objective of simplicity and transparency.

This example demonstrates that the narrow application results in an incentive for banks to bilaterally exchange variation margin in different currencies, i.e. in this case to post GBP 80 while receiving USD 100 and EUR 50. In this scenario the currency matching requirement in the narrow application is always fulfilled – independent of the interpretation - and thus the bank is able

- to fully offset the derivative mark-to-market exposure as the VM was received in USD and EUR to offset the derivative exposures of the derivatives with a positive market value in USD and EUR, and
- to exclude the cash receivable due to the posting of the GBP 80 due to the derivative liability in the same amount in GBP

Note however that such a bilateral exchange of VM will significantly increase Herstatt risk. Currently the market practice is to make a single net cash VM payment in an agreed transport currency. Breaking that netting would make individual VM currency flows go out at potentially different times. So a bank which has to pay VM in GBP but receives VM in USD would face a potentially significant intraday settlement risk if its counterparty defaults between cash-flows. This can be very significant amounts at coupon payment dates or at the maturity of large transactions.

European specificities for the repo market (in terms of maturities and market structures)

ANNEX 2: EUROPEAN SPECIFICITIES FOR THE OPEN END REPOS - Technical contribution from the French Banking Federation

An open repo (also known as *on demand* repo) is a repurchase agreement that is agreed without fixing the maturity date. Instead, the repo can be terminated on any day in the future by either party, provided they give notice before an agreed daily deadline. Until an open repo is terminated, it automatically rolls over each day. Interest accrues daily but is not compounded (i.e. interest is not earned each day on interest accrued over previous days). Outstanding interest is typically paid off every month.

The repo rate on an open transaction will be close to the overnight repo rate, but it will not change until the parties agree to re-set the rate. Open repo is used to invest cash or finance assets where the parties are not sure how long they will need to do so.

The maturity distribution of the European market is longer than overnight.

According to the 26th repo market survey (as of 11 December 2013 position) in January 2014, International Capital Market Association (ICMA) and the European Repo Council (ERC), on December 2013, the sum of repo and reverse repo outstanding (gross values of cash due to be repaid by you and repaid to you) is reaching EUR **5,499** billion. In Europe, the split by remaining term of maturity is as following:

- 6% repos are **open** end (of which more than 50% are tri-party transactions)
- 20% repos are **overnight** (term maturity 1 day)
- 9% repos are **forward-forward**
- 65% repos have a **term maturity >1 day**
 - 2 days to 1 week 16 %
 - 1 week to 1 month 22 %
 - >1 month to 3 months 17 %
 - >3 months to 6 months 5 %
 - >6 months to 12 months 3 %
 - >12 months 3%

Open repos share was 6% in December 2011, 13% in December 2012, 7% in June 2013 and 6% in December 2013.

In the leverage ratio BCBS 270 text, the requirement of “the same explicit final settlement date” for netting the cash legs generates an unlevel playing field for European repo market:

* European repos have more maturities to match

*Some European repos are open ended

Given the specificities of this market, we believe that BCBS and CRR texts should treat open maturity repos as overnight repos, as proposed by the GFMA FAQs.

ANNEX 3: EUROPEAN SPECIFICITIES FOR REPO SETTLEMENT - Technical contribution from the French Banking Federation

According to the 26th repo market survey (based on 11 December 2013 positions) published in January 2014 by the International Capital Market Association (ICMA) and European Repo Council (ERC), on December 2013, the outstanding sum of repo and reverse repo transactions (gross values of cash due) was EUR **5,499** billion.

1 - The bilateral transactions excluding those cleared through CCPs represent 50%-60% of the total European market share

In Europe, most bilateral repos are settled via delivery-versus-payment (DVP) mechanism, which links the securities and funds transfers to ensure that delivery occurs only if the corresponding payment occurs.

Cf. CPSS – Strengthening repo clearing and settlement arrangements – September 2010; Annex 2: Cross-country comparison of repo markets and repo infrastructure arrangements in selected CPSS countries; (e) Settlement; P45-46-47-48).

The settlement is done through **Central Securities Depositories (CSDs)**.

The two largest continental Central Securities Depositories (CSDs) Clearstream and Euroclear settle around 65% of repo transactions. (*the European Securities and Markets Authority (ESMA), March 2014 “Trends, Risks and Vulnerabilities”*)

2 - The European market share of CCP-cleared (anonymous electronic) trading amounts to 30% -40%.

CCP is the acronym for *central (clearing) counterparty*. In some markets, they are known as *clearing houses*. CCPs perform two so-called *clearing* functions:

- Once a transaction has been agreed between two parties and registered with a CCP, the CCP assumes a role in the transaction and becomes the buyer to every seller and the seller to every buyer, therefore replacing the original counterparty to both parties in the transaction. The CCP is typically AAA-rated as it collateralises its exposures; is backed by reserves, a default fund and other safeguards; and can ultimately fall back on its members.
- CCPs net transactions between members on a multilateral basis (netting by a CCP is referred to as “clearing”). This means that a delivery of a security due from parties A and B can be netted off against deliveries of the same security due on the same day to parties C and D. This produces a much smaller net exposure than bilateral netting, in which the parties can only net transactions with the same counterparty.

The proportion of repo turnover cleared across CCPs is likely to be even higher than the data available indicates due to the repos cleared by CCPs tend to be short-term transactions (the ECB’s money market survey suggests in the order of 40%).

The main repo CCPs in Europe are LCH-Clearnet Ltd in the UK, LCH-Clearnet SA in France, Eurex Clearing in Germany, CC&G in Italy and MEFF in Spain. Additionally, most CCP-cleared repos are negotiated on automatic repo trading systems such as BrokerTec, Eurex Repo and MTS.

3 - Tri-party repo transactions represent 10% of the total European market share

The outstanding value reported directly by the major tri-party agents in Europe reached a record figure of EUR 1,344 billion.

Synthesis	Parties to the trade	Administrative tasks	Risks
1 - OTC Repos (on a bilateral basis)	Bank A trades Principal-to-Principal with Bank B	- <u>Calculation agent</u> : Bank A & B - <u>Collateral eligibility</u> : determined by the CSA between Bank A & B - <u>Settlement of payments</u> : Bank A & B (through their Back-Office teams)	<u>Counterparty and settlement risks</u> against each bank
2 - Repos cleared through CCP	Bank A trades Principal-to-Principal with a CCP ("anonymous basis")	- <u>Calculation agent</u> : the CCP - <u>Collateral eligibility</u> : imposed by the CCP - <u>Settlement of payments</u> : Bank A & the CSDs (through their Back-Office teams)	<u>Counterparty and settlement risks</u> against the CCP
3 - Tri-Party repos	Bank A trades Principal-to-Principal with Bank B and a Clearing Bank acts as agent	- <u>Calculation agent</u> : the Agent Bank - <u>Collateral eligibility</u> : contractual or either General Collateral (GC) - <u>Settlement of payments</u> : the Agent Bank	<u>Counterparty risk</u> against each bank <u>Settlement risk</u> against the agent

In the BCBS 270 LR text, the settlement criteria for netting the cash legs may create uneven exposures between bilateral and tri-party repos in Europe, although bilateral transactions are settled through DVP and CSDs that guarantee a functional equivalent of net settlement.
 → Therefore the BCBS and CRR texts should accommodate for these European repo market specificities to avoid unintended consequences. The re-worded 33(i) c in the BCBS 270 should cover all European repos according to the economic exposures

The below technical details provide further detail in why all three types of European repo transactions should be eligible for the netting criteria:

- “*The counterparties intend to settle net*”: according to this criteria, all of the above transaction types should be eligible including CCP-cleared transactions
- “or settle simultaneously” – this covers DVP
- “*or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount at the end of the settlement date.*”

This will occur if the gross settlement mechanism has features that eliminate, or result in insignificant credit and liquidity risk. – this arrangement would have to apply for:

- a) transactions involving baskets of securities (where DVP is not possible because it would require cash-against-ISIN for every single security in the basket and therefore aggregate settlement on the settlement date equivalent to net of all the legs should be permissible),
- b) free-of-payment (FOP) purely bilateral transactions with the same counterparty, the same settlement date and the same ISIN number (which are settled leg-by-leg, as agreed by the counterparties)
- c) tri-party transactions, including transactions involving baskets of securities, where the settlement is internalized by the tri-party agent and it is done either simultaneously (i.e. it already falls under the previous criterion) or in most cases at the end of the day, on a net basis.

“To achieve such equivalence, both transactions are settled through the same settlement system” – We understand “settlement system” to mean a “settlement mechanism,” as specified in paragraph 33(i)(c) of the final Basel leverage ratio text. This is satisfied for a) and b) above when transactions are settling in a CSD (or an iCSD), as well as for c) when the settlement is internalized by the tri-party agent.

“...and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement.” – This would mean:

- a) and b): in the bilateral context where there is no DVP (i.e. not settled simultaneously), this condition would require that the counterparty has an intraday credit line with its custodian.
- c) in the tri-party context the tri-party agent would have to extend an intraday credit line to the counterparty for the purpose of securing the transaction.