REVISITING THE LEVERAGE RATIO

End-Users Appeal to Banking Regulators for Clearing Relief

By Will Acworth

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OVER THE COMING MONTHS, the Basel Committee on Banking Supervision will finish reviewing several proposed changes to the leverage ratio, one of the pillars of the global plan to strengthen the banking industry's capital requirements. These proposed changes include one question of tremendous importance to the cleared derivatives markets: whether to amend the leverage ratio's calculation methodology to recognize collateral posted by clients as an offset to the value of banks' derivatives exposure.

In April, the Basel Committee invited public comment on this question as part of its review of the leverage ratio, and the response was overwhelming. Out of the 53 responses it received in July, more than 30 advocated in favor of recognizing client collateral as an offset. These responses came not only from the banks that are directly impacted by leverage ratio, but also from a wide range of asset managers, pension funds, life insurance companies and other market participants that are alarmed at the potential impact on their ability to clear their derivatives trades.

These derivatives users warned the banking regulators that if the leverage ratio is not modified to recognize client collateral offsets, it will reduce their access to clearing services, endanger their ability to move positions from one clearing member to another and undermine the global commitment to greater use of central clearing as a way to reduce systemic risk in the financial system.

Numerous derivatives exchanges and clearinghouses also weighed into the debate, explaining the reasons why client collateral should not be treated as a source of leverage for the banks that collect that collateral, and urging the banking regulators to avoid weakening the ability of the clearing system to absorb the losses arising from the default of a clearing member.

Many other concerns about the leverage ratio were raised in the responses. For example, a number of exchanges, trading firms and banks urged the Basel Committee to adopt the so-called SA-CCR method for calculating derivatives exposures, saying it is more accurate than the current CEM model. And a number of asset managers and pension funds strongly urged the Basel Committee to widen the definition of collateral to include government bonds, rather than just cash.

But no issue received as much attention as the treatment of client collateral, which indicates just how important this issue is to the future of the cleared derivatives markets. In several cases, multiple institutions came together to file a single letter to highlight the industry-wide nature of their concerns. For example, five industry associations representing asset managers, hedge funds and commodity end-users filed a joint letter warning that an increase in the cost of clearing will make it difficult for their members to obtain clearing services at the very time that greater use of clearing is required.

"Many of our members have already experienced an increase in clearing costs," said the Alternative Investment Managers Association, the Commodity Markets Council, the Investment Association, the Managed Funds Association and the SIFMA Asset Managers Group. "Some have experienced the termination of a clearing relationship by their clearing broker, while overall central clearing is becoming more costly and more difficult to access. We therefore strongly caution against any measure that could further undermine the ability of the end-user community to access the benefits of central clearing, and ask the BCBS [Basel Committee] to revise the leverage ratio standard to allow an offset of client initial margin against a firm's potential future exposure."

The associations explained that the standardized approach for measuring counterparty credit risk exposures, as proposed, does not allow the initial margin posted by clients to offset a clearing member's potential future exposure to loss on client positions in derivatives, even though the margin is collected expressly for that purpose.

"We do not believe this approach is justified," the five associations said. "Client IM serves to reduce the exposure that arises for a clearing member by virtue of its guaranteeing its client's performance to the CCP [clearinghouse] and is a fundamental component of rules that seek to ensure that CCPs are financially sound. This IM cannot be used by the clearing member for any other purpose and does not enable it to lever its positions."

Overstated Exposures

European pension funds were particularly outspoken about the potential impact on their ability to clear. Pensions Europe, a trade association for pension funds, explained that pension funds tend to hold long-term interest rate swaps to hedge their liabilities, and as a result, have a very "directional" exposure that cannot be reduced by netting. Not recognizing client collateral would "disproportionately overstate" the derivatives exposures of their clearing firms, making it that much more expensive for the clearing firms to continue providing clearing services to pension funds.

APG Asset Management, a Dutch asset manager that works exclusively for pension funds, added that European pension funds are currently exempted from clearing requirements. When that exemption expires, however, the impact will be "devastating" for their clearing portfolios because of the risk profile of their positions, APG warned.

"The OTC derivatives portfolios of pension funds are typically long-dated and one-directional in nature to offset the liability risk pension funds have," APG said. "This reflects the long-dated nature of the liabilities of pension funds. The nature of the derivatives portfolios of pension funds magnifies any intended or unintended consequences of OTC derivatives regulations to pension funds. We believe this is unjustified given the credit quality of European pension funds, and as the OTC derivatives portfolios offset risks that are naturally inherent for pension funds and therefore help pension funds to reach a minimal risk position."

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Another concern raised by derivatives end-users was the potential impact on "porting," the term used to describe moving assets and positions from one clearing firm to another. The Investment Association, which represents the U.K. asset management industry, warned that the impact of capital requirements is leading to a decrease in the number of banks willing to provide clearing services, which will make it more difficult for asset managers to find a new home for their cleared positions, the IA warned. Allowing an offset for client collateral would ease the "burden" on clearing firms, the IA said, and lead to more choices for customers. More importantly, it would reduce the possibility that in a financial crisis, the collapse of a major bank would leave its customers stranded.

"The shrinking market for clearing members puts into question whether porting can really work in either stressed market conditions or in the event of a clearing member default," the IA said. "For client clearing to be robust and resilient in an environment where clearing is mandated internationally, end-users need a greater supply of, and competition among, banks willing to provide clearing broker services. Allowing client IM to offset OTC derivatives exposures to cleared trades goes somewhat toward helping to relieve the capital burden on banks for clearing broker services, which should make the client clearing business more viable for banks and more cost effective for clients."

Access to Clearing

SIFMA AMG, which represents the U.S. asset management industry, put numbers to these comments by conducting a survey of its members. The group found that roughly half of the respondents had been asked to pay higher clearing fees, and a sizeable minority had been terminated from clearing relationships.

"The AMG survey results show that the Basel leverage ratio's failure to recognize the exposure-reducing effect of segregated initial margin is already having a negative impact on AMG members' ability to hedge their clients' risks and reduce volatility," SIFMA AMG said. "We are greatly concerned that this effect will only be magnified as the Basel leverage ratio becomes a binding minimum requirement," the group said.

The American Council of Life Insurers, which represents the U.S. life insurance industry, said its members have experienced many of the same effects reported in the SIFMA AMG survey. These effects have a "particularly sharp impact" on life insurance companies, ACLI said, because they generally trade less frequently trading and use more directional trading strategies than other end-users.

"In short, central clearing is becoming more costly and more difficult to access. Because life insurers' primary use of derivatives is for hedging the risks associated with their investments portfolios and insurance and annuity product liabilities, the general impact of the proposed approach would restrict the insurance industry's ability to manage and hedge financial risk. These collateral consequences seem contrary to overall stability in the derivatives marketplace," ACLI said.

Collateral Protections

These concerns were echoed by exchanges and clearinghouses. A joint letter from two groups that represent more than 50 clearinghouses worldwide, the CCP12 and the European Association of Clearing Houses, acknowledged the purpose of the leverage ratio is to limit the build-up of leverage in the banking system, an important factor in the 2008 financial crisis. They explained, however, that the initial margin posted by clients is subject to protections embedded in national laws, client money rules and clearinghouse requirements that prevent banks from using it to leverage their own positions.

"Client collateral must be held to support the client's positions only; the collateral in most cases must be held in an account segregated from the bank's funds, and the bank is unable to access this collateral except when losses resulting from the client's position need to be covered," the two groups said.

The two groups also emphasized the potential systemic risk that could arise in the event of a clearing member default. If client portfolios are burdened by expensive capital requirements, solvent clearing members may be less likely to accept the clients of the defaulting clearing member, they warned. This may force the clearinghouse to liquidate the client portfolios, leading to greater market uncertainty and instability.

"The G-20 mandate was designed to move markets toward central clearing because regulators appreciated the security provided by centrally cleared markets," the two groups said. "These markets are already subject to rigorous regulatory standards, including the collection and segregation of margin to support client margins. It is critical that these standards be recognized and accounted for by the leverage ratio to ensure clients are able to access the cleared markets and without the requirement to concentrate their exposures into a small number of large CCP clearing members."

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These concerns were underscored by letters from two individual clearinghouses. CME Clearing, the clearinghouse arm of CME Group, pointed out that clearinghouses worldwide hold more than $300 billion in segregated customer collateral. The "sole purpose" of these funds is to offset the potential future exposures arising from those customers' derivatives positions at a CCP, CME said, and therefore, the funds should be taken into account in the leverage ratio calculations.

CME also echoed the concerns about the potential obstacles to porting customer positions, saying that the additional capital requirement would discourage banks from taking on new customers.

"Today, many bank-affiliated clearing firms are evaluating whether to cease offering client clearing services, and the proposed revisions will only continue this debate due to the significant cost impact of the Basel III leverage ratio on providing client clearing services," CME said. "Furthermore, the costs of the leverage ratio to clearing members will likely narrow the range of clients with central clearing access, subjecting those firms to increased risk exposures while also decreasing diversification in central clearing, which could result in reduced liquidity and increased concentration risk in the market."

Front-Line Defense

LCH.Clearnet Group made similar arguments, and added that it had calculated the impact on members of SwapClear, its interest rate swap clearing service. LCH estimated that failing to recognize the exposure-reducing effect of initial margin under the SA-CCR methodology "would more than double the amount of capital required" across the membership of SwapClear. LCH added that clearing members will be forced to pass these increased capital costs down to their clients, making clearing more expensive at the same time that the number of clients and products subject to clearing mandates continues to increase globally.

"As central counterparty risk managers, we believe IM is the front line defense in the clearing industry which protects clearing members, clients and the broader financial markets from counterparty risk," LCH said. "Failure to recognize this risk-reducing effect is contrary to the broader goals of prudential and market regulators to promote an appropriate balance between margin and capital and to ensure a more resilient clearing industry."