Basel Committee
on Banking Supervision

# Consultative Document

# Leverage ratio treatment of client cleared derivatives

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# Leverage ratio treatment of client cleared derivatives

## Background

A key element of the Basel Committee's post-crisis Basel III reforms is the introduction of a leverage ratio requirement. The leverage ratio complements the risk-based capital requirements by providing a safeguard against unsustainable levels of leverage and by mitigating gaming and model risk across both internal models and standardised risk measurement approaches. By design, the leverage ratio does not differentiate risk across different asset classes.

With most of the Committee's post-crisis policy reform agenda complete, the Committee is evaluating and monitoring the impact of its reforms. As part of the finalised Basel III reforms published in December 2017, the Committee noted that it would "continue to monitor the impact of the [...] leverage ratio's treatment of client cleared derivative transactions and, within two years after [...] publication of this document, conclude a review of the impact of the leverage ratio on banks' provision of clearing services and any consequent impact on the resilience of central counterparty clearing".[1]

In conducting its review, the Committee has considered quantitative and qualitative information it has collected, in addition to insights gained through a joint evaluation conducted by the Committee, the Financial Stability Board, the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions of the effects of post-crisis reforms on incentives to centrally clear over-the-counter derivatives, consistent with the G20 Leaders' commitments to reform OTC derivatives markets.[2]

The Committee's post-crisis reforms and the aforementioned review were motivated by key policy objectives set by G20 Leaders: (i) to strengthen regulatory frameworks, prevent excessive leverage and improve the quality and quantity of capital in the banking system;[3] and (ii) to promote central clearing of standardised derivative contracts as part of mitigating systemic risk and making derivatives markets safer.[4]

In light of these overarching policy objectives, the Committee seeks the views of stakeholders as to whether a targeted and limited revision of the leverage ratio exposure measure is warranted with regard to the treatment of client cleared derivatives. Stakeholders are invited to provide supporting concrete and robust empirical evidence as to whether the existing treatment should be revised.

Absent a strong evidence-based case to revise the treatment, the Committee will retain the existing treatment of client cleared derivatives as currently set out in the framework ("Option 1"). This approach would adhere to the leverage ratio principle that "banks must not take account of physical or

1 Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms*, December 2017, www.bis.org/bcbs/publ/d424.pdf.

2 BCBS, CPMI, FSB and IOSCO, *Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms*, August 2018, www.fsb.org/wp-content/uploads/P070818.pdf.

3 See eg Communiqué of the G20 Leaders' Summit, London, April 2009, www.g20.utoronto.ca/2009/2009communique0402.pdf.

4 See eg Communiqué of the G20 Leaders' Summit, Pittsburgh, September 2009, www.g20.utoronto.ca/2009/2009communique0925.html.

financial collateral, guarantees or other credit risk mitigation techniques to reduce the leverage ratio exposure measure."

The Committee seeks the views of stakeholders on two potential targeted revisions, which it could make if it considers after consultation that there is a strong evidence-based case for revising the current leverage ratio treatment of client cleared derivatives. For each of these potential revisions, the Committee welcomes views from stakeholders on the materiality of the impact of the revisions on leverage ratio capital requirements and on the anticipated impact the revisions might have on client clearing service provision in general.

One option ("Option 2") would amend the currently specified treatment of client cleared derivatives to allow amounts of cash and non-cash initial margin (ie "independent collateral amount" as defined per the standardised approach to measuring counterparty credit risk exposures, or SA-CCR)[5] that are received from the client to offset the potential future exposure of derivatives centrally cleared on the client's behalf.

Another option ("Option 3") would amend the currently specified treatment of client cleared derivatives to align it with the measurement as determined per the SA-CCR as used for risk-based capital requirements. This option would permit both cash and non-cash forms of initial margin and variation margin received from the client to offset replacement cost and potential future exposure for client cleared derivatives only.

Revisions to the leverage ratio standard text that could serve to implement these potential changes are set out in the Annex to this document.

The Committee also seeks views on the merit of requiring that any forms of initial margin to be made eligible for offsetting client cleared derivative exposures be subject to segregation criteria so as to ensure that those amounts will be available in the event of a client's default. Such segregation criteria could include requirements that initial margin be recorded as separate from the clearing member bank's own assets and be legally segregated in the event of default of the entity that holds the margin, and could specify limitations on the permitted uses by clearing member banks of initial margin received from clients. Banks that currently offer derivatives client clearing services are welcome to share details of the segregation criteria to which they currently adhere and insights into the effectiveness of those criteria to safeguard the amount of initial margin provided by clients in the event of default. The text included in the Annex to this document does not include any segregation criteria that may be considered based on feedback to this consultative document.

## Next steps

The Committee welcomes comments from the public on all aspects of this consultative document, and in particular the following questions:

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

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

[5] Basel Committee on Banking Supervision, *The standardised approach for measuring counterparty credit risk exposures*, March 2014 (revised April 2014), www.bis.org/bcbs/publ/d424.pdf.

banking system by preventing excessive leverage and promoting central clearing of standardised derivative contracts?

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?

Comments must be submitted by 16 January 2019 and will be published on the Bank for International Settlements website unless a respondent specifically requests confidential treatment.

Once the Committee has reviewed responses and completed its own further analyses, it intends to publish its conclusion on the treatment of client cleared derivatives within an appropriate time frame.

# Annex 1

## Proposed revisions to leverage ratio standard text to implement client initial margin offset of potential future exposure for client cleared derivatives

"Option 2" outlined above could be implemented by means of the following revisions to the Annex of the revised leverage ratio framework. Changes to the text relative to the version published in December 2017 are reflected in red font. This text does not include additional segregation criteria that may be considered based on feedback to this consultative document.

[. . .]

## Derivative exposures

1. The calculation of derivative exposures for the leverage ratio exposure measure is based on a modified version of the standard set out in Annex 4 of the Basel II framework as amended by *The Standardised Approach for measuring counterparty credit risk exposures* (hereafter "SA-CCR framework").[Footnote 1]

Footnote 1 Basel Committee on Banking Supervision, The standardised approach for measuring counterparty credit risk exposures, March 2014 (revised April 2014), www.bis.org/publ/bcbs279.pdf.

### Calculation of replacement cost

2. The replacement cost of a transaction or netting set is measured as follows:

$$RC = \max\left\{V - CVM_r + CVM_p, 0\right\}$$

where (i) V is the market value of the individual derivative transaction or of the derivative transactions in a netting set; (ii) $CVM_r$ is the cash variation margin *received* that meets the conditions set out in paragraph 39 and for which the amount has not already reduced the market value of the derivative transaction V under the bank's operative accounting standard; and (iii) $CVM_p$ is the cash variation margin *provided* by the bank and that meets the same conditions.

### Calculation of potential future exposure

3. The potential future exposure (PFE) for derivative exposures must be calculated in accordance with paragraphs 146 to 187 of Annex 4 of the SA-CCR framework. Mathematically:

$$PFE = multiplier \cdot AddOn^{aggregate}$$

For the purposes of the leverage ratio framework, the multiplier is fixed at one for derivative exposures other than those specified in paragraph 3a of this Annex. Moreover, when calculating the add-on component, for all margined transactions the maturity factor set out in paragraph 164 of Annex 4 of the SA-CCR framework may be used. Further, as written options create an exposure to the underlying, they must be included in the leverage ratio exposure measure by applying the treatment described in this Annex, even if certain written options are permitted the zero exposure at default (EAD) treatment allowed in the risk-based framework.

3a. For derivative exposures associated with the bank's offering of client clearing services, the PFE of the exposure to the client (or to the "lower level client" in the case of a multi-level client structure)[Footnote 2] as defined in paragraph 41 may be calculated in accordance with paragraphs 146 to 187 of Annex 4 of the SA-CCR framework. Mathematically:

$$PFE = multiplier \cdot AddOn^{aggregate}$$

For the purposes of the leverage ratio framework, the multiplier is calculated as follows:

$$multiplier = \min\left\{1; Floor + (1 - Floor) * exp\left(\frac{V - ICA}{2 * (1 - Floor) * AddOn^{aggregate}}\right)\right\}$$

where *ICA* is the independent collateral amount, which in accordance with paragraph 142 of the SA-CCR framework represents (i) collateral (other than VM) posted by the counterparty that the bank may seize upon default of the counterparty, the amount of which does not change in response to the value of the transactions it secures and/or (ii) the independent amount (IA) parameter as defined in standard industry documentation. In accordance with paragraph 149 of the SA-CCR framework, the *Floor* is 5%.

Moreover, when calculating the add-on component, for all margined transactions the maturity factor set out in paragraph 164 of Annex 4 of the SA-CCR framework may be used.

Footnote 2 The term "lower level client" refers to the institution that clears through that client.

[. . .]

# Annex 2

## Proposed revisions to leverage ratio standard text to implement use of unmodified SA-CCR to measure exposures to client cleared derivatives

"Option 3" outlined above could be implemented by means of the revisions to the following paragraphs of the revised leverage ratio standard. Changes to the text relative to the version published in December 2017 are reflected in red font. This text does not include additional segregation criteria that may be considered based on feedback to this consultative document.

[. . . ]

41. *Treatment of clearing services*: where a bank acting as clearing member (CM)[Footnote 1] offers clearing services to clients, the CM's trade exposures to the central counterparty (CCP) that arise when the CM is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults must be captured by applying the same treatment that applies to any other type of derivative transaction. However, if the CM, based on the contractual arrangements with the client, is not obligated to reimburse the client for any losses suffered in the event that a QCCP defaults, the CM need not recognise the resulting trade exposures to the QCCP in the leverage ratio exposure measure. In addition, where a bank provides clearing services as a "higher level client" within a multi-level client structure,[Footnote 2] the bank need not recognise in its leverage ratio exposure measure the resulting trade exposures to the CM or to an entity that serves as a higher level client to the bank in the leverage ratio exposure measure if it meets all of the following conditions:

- The offsetting transactions are identified by the QCCP as higher level client transactions and collateral to support them is held by the QCCP and/or the CM, as applicable, under arrangements that prevent any losses to the higher level client due to: (i) the default or insolvency of the CM, (ii) the default or insolvency of the CM's other clients, and (iii) the joint default or insolvency of the CM and any of its other clients;[Footnote 3]
- The bank must have conducted a sufficient legal review (and undertake such further review as necessary to ensure continuing enforceability) and have a well-founded basis to conclude that, in the event of legal challenge, the relevant courts and administrative authorities would find that such arrangements mentioned above would be legal, valid, binding and enforceable under relevant laws of the relevant jurisdiction(s);
- Relevant laws, regulation, rules, contractual or administrative arrangements provide that the offsetting transactions with the defaulted or insolvent CM are highly likely to continue to be indirectly transacted through the QCCP, or by the QCCP, if the CM defaults or becomes insolvent.[Footnote 4] In such circumstances, the higher level client positions and collateral with the QCCP will be transferred at market value unless the higher level client requests to close out the position at market value; and
- The bank is not obligated to reimburse its client for any losses suffered in the event of default of either the CM or the QCCP.

Footnote 1 For the purposes of this paragraph, the terms "clearing member", "trade exposure", "central counterparty" and "qualifying central counterparty" are defined as in Annex 4, Section I, A. General Terms of the Basel II framework as amended.

Footnote 2 A multi-level client structure is one in which banks can centrally clear as indirect clients; that is, when clearing services are provided to the bank by an institution which is not a direct clearing member, but is itself a client of a clearing member or another clearing client. The term "higher level client" refers to the institution that provides clearing services.

Footnote 3 That is, upon the insolvency of the clearing member, there is no legal impediment (other than the need to obtain a court order to which the client is entitled) to the transfer of the collateral belonging to clients of a defaulting clearing member to the QCCP, to one of more other surviving clearing members or to the client or the client's nominee.

Footnote 4 If there is a clear precedent for transactions being ported at a QCCP and industry intent for this practice to continue, then these factors must be considered when assessing if trades are highly likely to be ported. The fact that QCCP documentation does not prohibit client trades from being ported is not sufficient to say they are highly likely to be ported.

41a. Pursuant to paragraph 41, for derivative exposures associated with the bank's offering of client clearing services, the RC and the PFE of the exposure to the client (or the exposure to the "lower level client" in the case of a multi-level client structure) may be calculated according to paragraphs 139 to 187 of Annex 4 of the Basel II framework as amended by *The standardised approach for measuring counterparty credit risk exposures*.[Footnote 5]

Footnote 5 The term "lower level client" refers to the institution that clears through that client.

42. Where a client enters directly into a derivative transaction with the CCP and the CM guarantees the performance of its client's derivative trade exposures to the CCP, the bank acting as the CM for the client to the CCP must calculate its related leverage ratio exposure resulting from the guarantee as a derivative exposure as set out in paragraphs 33 to 40, as if it had entered directly into the transaction with the client, including with regard to the receipt or provision of cash variation margin.

43. For the purposes of paragraphs 41 and 42, an entity affiliated to the bank acting as a CM may be considered a client if it is outside the relevant scope of regulatory consolidation at the level at which the leverage ratio is applied. In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation but the CM still has a trade exposure to the CCP. In this case, the transaction with the CCP will be considered proprietary and the exemption in paragraph 41 will not apply.

[. . . ]