

May 15th, 2017

Hong Kong Monetary Authority  
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***Response on consultation paper CP 17.03: Implementation of Basel III Leverage Ratio Framework***

Dear:

This letter contains the response of The Global Association of Central Counterparties (**CCP12**) to the Hong Kong Monetary Authority (**HKMA**) consultation paper *Implementation of Basel III Leverage Ratio Framework* (the **Consultation**) issued for comment on 13 April 2017.

CCP12 is a global association of 35 major central counterparty (“CCP”) organizations in Europe, Asia and the Americas. CCP12 was formed to share information, develop analyses and develop policy standards for common areas of concern. CCP12 members work toward the common purpose of creating conditions in which a global CCP solution can emerge to meet the needs of the marketplace.

We generally support the implementation of the leverage ratio framework as outlined in the Consultation, specifically the two phase approach to further assess the forthcoming final guidance from the Basel Committee on Banking Supervision (**BCBS**). Our comments in this response relate to the ongoing regulatory and industry discussions and assessment of the leverage ratio impact to the cleared markets as currently drafted in the BCBS guidance.

The BCBS issued a consultative document in April of 2016 that acknowledged significant industry concern related to the leverage ratio’s impact on central clearing and have stated that “... further evidence and data on the impact of the Basel III leverage ratio on client clearing and on [clearing members’] business models should be collected...”<sup>1</sup> Therefore, we would like to take the opportunity to reiterate the concerns that we, together with the European Association of CCP Clearing Houses, expressed in response to the BCBS consultative document related to (1) the ability to recognize segregated margin posted on behalf of clients and (2) the ability to assign the appropriate margin period of risk for cleared positions. Expanded details of these concerns can be found in the attached letter.

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<sup>1</sup> BCBS Consultative Document, *Revisions to the Basel III leverage ratio framework*, April 2016. Refer to II.1.2 Impact assessment on the client clearing business. <http://www.bis.org/bcbs/publ/d365.htm>

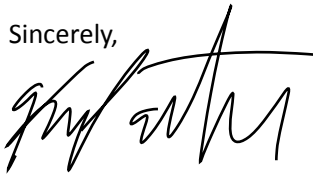
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Note that industry concerns have been acknowledged further by regulatory agencies in the United States and European Union for which we anticipate further discussion. CCP12 urges the HKMA to consider such discussions when advancing the implementation of the leverage ratio framework in Hong Kong.

We are concerned that the treatment of cleared derivatives in the leverage ratio framework as drafted by the BCBS may disincentivize central clearing, specifically on behalf of clients, directly in contrast to the G20 objectives, which may act to inhibit market transparency, liquidity and efficiency.

CCP12 appreciates the opportunity to share these comments and would be interested to further discuss the concerns expressed on this issue. If you require any further information, please contact Ketan Patel ([KetanPatel@hkex.com.hk](mailto:KetanPatel@hkex.com.hk)) and Marcus Zickwolff ([Marcus.Zickwolff@ccp12global.com](mailto:Marcus.Zickwolff@ccp12global.com)).

Sincerely,



Ketan Patel  
CCP12 Vice-Chair Asia-Pacific  
Hong Kong Exchanges and Clearing Limited



Marcus Zickwolff  
CCP12 Chief Executive Officer  
The Global Association of Central Counterparties

Attachment

CCP12 and EACH joint response to Basel Committee on Banking Supervision Consultation (6 July 2016)

**Via Electronic Mail**

6 July 2016

The Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland

**RE: Basel Committee on Banking Supervision - Consultative Documents**

Dear Committee Members:

CCP-12 is a global association of 34 major central counterparty (“CCP”) organizations in Europe, Asia and the Americas. CCP-12 was formed to share information, develop analyses and develop policy standards for common areas of concern. The CCP-12 members work toward the common purpose of creating conditions in which a global CCP solution can emerge to meet the needs of the marketplace. The member list of the CCP-12 is included in Annex 1 to this letter.

The European Association of CCP Clearing Houses (“EACH”) represents the interests of CCPs in Europe since 1992. EACH currently has 20 members from 16 different European countries. EACH is registered in the European Union Transparency Register with number 3689701131196.

This letter represents our position on the Basel Committee on Banking Supervision (“BCBS”) revisions to the Basel III Leverage Ratio Framework (“Leverage Ratio”). CCP-12 and EACH appreciates the opportunity to provide comments to the BCBS on this important issue.

**Overview**

In its revised Leverage Ratio proposal, we were pleased to see the BCBS has made some important changes to their proposal. Specifically, the introduction of the Standard Approach for Measuring Counterparty Credit Risk (“SA-CCR”) model is generally for most types of portfolios an improvement on the Current Exposure Method (“CEM”).

As the Committee has noted in its publications, criticisms of CEM rightly point out issues with the calculation, including not differentiating between margined and unmargined trades and improper recognition of hedging and netting benefits.<sup>1</sup> We believe that weaknesses in the calculation result in punitive charges that do not take into account crucial risk reducing metrics in derivatives contracts, disregarding both delta adjusted notional to reflect exposure and netting between options on the same underlying contract. Improperly calculating capital charges for these portfolios will unnecessarily increase capital costs and create further pressure for market makers to exit the business, potentially leading to reduced depth and lower liquidity in key derivatives markets.

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<sup>1</sup> BCBS 279: The standardised approach for measuring counterparty credit risk exposures;  
BSBC 254: The non-internal model method for capitalising counterparty risk exposures

Additionally, we appreciate the Committee’s efforts to recognize the risk reducing benefits of central clearing through the lower margin period of risk for cleared products. Understanding the reduced risks of centrally cleared trades is crucial to maintaining capital to accurately support the trading portfolio without diminishing the incentives to bring trades to a CCP, which reduces systemic risk for the whole market. These are important steps in achieving the goals of the Committee – goals that we share – namely, to improve the safety and stability of financial markets.

As much as we believe the proposed revisions to the Leverage Ratio has improved the accuracy of the capital calculations, there are areas of continued concern that will disincentivize central clearing and result in a reduced utilization of clearing services, the very services that regulators agree help improve market transparency and security. In order to ensure the on-going maintenance of the incentives that keep these crucial services attainable and attractive to market participants as new regulatory and capital standards are developed, we believe the BCBS should re-evaluate certain aspects of the leverage ratio to align the interests of regulators, CCPs, and market participants.

## Specifics

We appreciate and support the goal of the leverage ratio, designed to provide a backstop to risk-based requirements and limit the build-up of leverage. However, in doing so, it is important that regulations do not create overly onerous capital requirements that produce inadvertent hurdles to clearing trades.

## Recognition of Segregated Margin posted on behalf of Clients

In its current calculation, the Leverage Ratio requires clearing member banks to assign equal treatment to centrally cleared client trades as their own proprietary trades, without any consideration for the collateral posted by the clients to offset this exposure, particularly segregated margin.<sup>2</sup> Indeed, the most liquid form of margin from clients – cash – is generally added to the clearing member’s leverage ratio.<sup>3</sup> This has dramatic implications not only for the banks directly impacted but also for the clients looking for banks to clear on their behalf.

## Concerns

Where we understand the BCBS’s concerns that collateral received by the bank “can increase the economic resources at the disposal of the bank” and that the collateral itself can be used by the bank to increase leverage, this concern ignores the nature of and protections surrounding client collateral. Client collateral must be held to support the client’s positions only; the collateral in most

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<sup>2</sup> “Segregated margin” in this context refers to margin (excluding variation margin) provided to a clearing member by its client that cannot be used by that member to leverage itself due to national laws, regulatory/client money rules or clearinghouse requirements that prevent clearing members from using posted collateral for purposes other than collateralising client exposure, including, for example, rules issued by the Commodity Futures Trading Commission, e.g., 17 C.F.R. §§ 1.20-1.30 (futures) and 17 C.F.R. §§ 22.2- 22.7 (cleared swaps), rules issued under the UK Client Asset Sourcebook (“CASS”) regime, e.g., CASS 7.3.1R and CASS 7.4.1R, and Article 39 EMIR. Segregated margin usually consists of initial margin.

<sup>3</sup> Some jurisdictions support accounting rules that require segregated cash margin to be considered an on-balance sheet asset of the receiving bank clearing member; this results in the segregated cash to be included as a separate leverage exposure in the bank’s leverage ratio.

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 client's position needs to be covered. The bank cannot use the collateral to leverage itself.

Without accounting for this collateral, the more than \$300 billion in segregated customer collateral held in centrally cleared markets is effectively ignored, or indeed added to the clearing members' leverage exposure.<sup>4</sup> As a result, the leverage ratio will not serve as the backstop or floor it was designed to provide. Rather, the leverage ratio will continue to be a binding constraint on centrally cleared derivative exposures even under the SA-CCR approach, limiting access to the transparency and benefits of a centrally cleared market.

### **Increased Systemic Risk**

The limits of the currently proposed Leverage Ratio will become particularly troublesome in the event of a clearing member default. Solvent clearing members play a crucial role in the cleared markets during a clearing member default, including their assistance in porting clients of the defaulter and transferring those positions. If client portfolios are burdened by expensive capital requirements, despite the collateral also ported to support the positions, solvent clearing members may be less likely to accept the clients of the defaulter. While clearing members must perform risk analysis on the clients and their portfolios before determining if they can accept the client, even if clearing members are willing to accept the client portfolios, they will be unable to accept the client portfolios unless they can afford higher capital charges. Creating additional obstacles to this process through higher capital costs will make it more difficult to port clients, increasing uncertainty for solvent clients in a time of significant market stress during a clearing member default.

In an extreme scenario, where no solvent clearing member is able to accept the new client – whether through a risk decision or because they cannot afford the capital costs associated with the capital requirements – the CCP may be forced to liquidate the client portfolio. Liquidating what would likely be a large portfolio into a distressed market will worsen the instability caused by the initial default, and the inability of clients to access the cleared market will create even greater uncertainty in the market.

The industry has seen a significant decline in the number of clearing members willing and able to offer client services. As an example, the United States data from the Commodity Futures Trading Commission (“CFTC”) shows 70 Futures Commission Merchants (“FCMs”) – firms that execute futures derivatives orders on behalf of customers – registered as of April 2016. In April 2002, that number was nearly 170.<sup>5</sup> A number of factors have led to this decline in FCMs, but the fact remains that clients already have fewer options to access the cleared market. Creating additional expenses for members clearing client positions will only exacerbate this pressure on clearing members, further reducing clients' options and increasing the concentration of positions in the smaller number of clearing members still able to support client clearing.

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<sup>4</sup> Customer segregated margin is reported in the quantitative disclosure developed by CPMI IOSCO to ensure uniform reporting of figures for market participants. Details available here:

<http://www.bis.org/cpmi/publ/d125.pdf>

<sup>5</sup> [http://www.cftc.gov/MarketReports/FinancialDataforFCMs/HistoricalFCMReports/index.htm#P430\\_3035](http://www.cftc.gov/MarketReports/FinancialDataforFCMs/HistoricalFCMReports/index.htm#P430_3035)

The G-20 mandate was designed to move markets towards central clearing because regulators appreciated the security provided by centrally cleared markets. 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.

## **Recommendation**

We strongly recommend that the BCBS (a) allow banks to offset segregated margin on behalf of clients against their client trades for purposes of calculating leverage ratio exposures, and (b) acknowledge that clearing members who meet the appropriate accounting criteria for segregation should also be able to remove cash posted as margin from their own balance sheet calculations for the purpose of determining the leverage ratio.

## **Margin Period of Risk**

We recognize and appreciate the BCBS's proposal for the margin period of risk ("MPOR") for centrally cleared derivatives, moving from the previously proposed 10-day MPOR to the newly proposed 5-day. This is an important recognition of the security of centrally cleared trades and the rigorous margin being applied to these positions.

## **Recognition of Liquidation Periods for Different Products**

That said, we believe there are further improvements to be made to ensure the leverage ratio properly accounts for the risk of centrally cleared trades and the capital necessary to support them.

In the current calculation, an MPOR of five days is applied to all cleared transactions that are centrally cleared, not taking into account the differences between various cleared products or their risk profiles. Currently, over-the-counter ("OTC") derivatives cleared at a central counterparty are margined at a 5-day MPOR under global standards and principles. This is broadly seen as an appropriate measure of the liquidation period necessary to protect against the default of a clearing member. This reflects the limited transparency of the OTC market and ensures the clearinghouse has sufficient margin on hand to cover the risk of these specific products.

Compared to OTC products, exchange traded derivatives ("ETDs") are more standardized and the market is more transparent. Generally, global standard setters have determined that the differences between these markets should be reflected in the MPOR used for CCPs. We agree with global standard setters that given their different characteristics compared with OTC derivatives, a lower MPOR should be applied to ETDs. Currently, most regional jurisdictions have implemented a lower minimum MPOR for ETDs of up to two days, as this is a sufficient period to liquidate these products.

Subjecting ETD products to the same capital charges as OTC products effectively ignores both the distinction that has been made by global and regional regulators and the important differences between these kinds of products. Treating these products with the same capital costs will reduce incentives to use ETD products – products with established liquidity and transparency – as the capital costs will be just as high as the costs for OTC products.

## Recommendation

We recommend that the BCBS apply the 5-day MPOR to centrally-cleared OTC products as currently proposed, but apply an MPOR to ETD products that has proven to be adequate in line with the applicable regulatory framework. This appropriately reflects the liquidity of these products and ensures international comity.

## Conclusion

CCP-12 and EACH appreciate and support the goals of the BCBS and the leverage ratio to restrict the build-up of leverage in banks to support greater stability in the market. We appreciate the efforts made by the BCBS to adjust the leverage ratio to properly reflect the risk reduction provided by central clearing. This is critical to meeting both the needs of the BCBS as well as the G-20 mandate to move markets towards the security of central clearing.

As an overarching theme, we encourage the BCBS to consider the ultimate impact of its reforms not just to the banks subject to its rules, but also the cleared markets and positions captured by their regulations. CCPs have developed carefully balanced risk-based incentive structures that have successfully navigated every major financial stress in modern history. This is particularly important in areas that have been established by global and regional jurisdictions, such as client segregation and margin calculations.

Central clearing is an important tool for managing the risks inherent in the financial products that are used by market participants from bankers to farmers. Equally important is the liquidity of these products and access to the cleared markets on which they trade. Applying over punitive charges to these products, which are products that are subject to established and heavily regulated CCP rules, could drive firms away from client clearing or out of the cleared space all together, concentrating exposures and increasing costs to end users. These charges could disincentivize market making, reducing market liquidity and increasing the cost of accessing vital markets. Additionally, adding cash collateral to leverage calculations will create incentives to pledge securities rather than cash, increasing demand on specific securities and reducing liquidity in these products. This will hurt markets in day-to-day functions and especially in times of crisis when liquidity and market participation is crucial.

We appreciate the opportunity to comment to the BCBS on this important matter and look forward to continuing to work towards our shared goals of market stability and customer security.

Sincerely,



Lee Betsill  
Chairman, CCP-12



Simon Turek  
Chairman, EACH



## Annex I

### CCP-12 Members

ASX Limited (ASX)  
BM&F Bovespa (BM&F)  
Cámara de Riesgo Central de Contraparte de Colombia S.A (CRCC)  
Cassa di Compensazione e Garanzia S.p.A. (CC&G)  
Chicago Mercantile Exchange Group (CME)  
ComDer Contraparte Central (ComDer)  
Contraparte Central S.A. (CCLV)  
Depository Trust & Clearing Corporation (DTCC)  
Dubai Commodities Clearing Corporation (DCCC)  
Eurex Group (Eurex)  
Grupo BMV (BMV)  
Hong Kong Exchanges & Clearing Ltd (HKEx)  
Indian Clearing Corporation Ltd. (ICCL)  
Intercontinental Exchange (ICE)  
Japan Securities Clearing Corporation (JSCC)  
Johannesburg Stock Exchange (SAFCOM)  
KDPW\_CCP (KDPW)  
Kliring Penjaminan Efek Indonesia (KPEI)  
Korea Exchange (KRX)  
LCH.Clearnet Group Ltd (LCH)  
Mercado de Valores de Buenos Aires S.A. (Merval)  
Nasdaq Clearing (Nasdaq)  
Bank National Clearing Centre (Joint-stock company) (NCC Clearing Bank)  
National Clearing Company of Pakistan Limited (NCCPL)  
National Securities Clearing Corporation Limited (NSCCL)  
Shanghai Clearing House (SHCH)  
Singapore Exchange Ltd (SGX)  
Taipei Exchange (TPEX)  
Taiwan Futures Exchange (Taifex)  
Taiwan Stock Exchange (TWSE)  
Thailand Clearing House Co. Ltd. (TCH)  
The Clearing Corporation of India Ltd (CCIL)  
The Options Clearing Corporation (OCC)  
TMX Group (TMX)



## **EACH Members**

ATHEXClear  
BME Clearing  
CC&G (Cassa di Compensazione e Garanzia S.p.A.)  
CCP Austria  
CME Clearing Europe  
ECC (European Commodity Clearing AG)  
Eurex Clearing AG  
EuroCCP  
ICE Clear Europe  
IRGiT S.A. (Warsaw Commodity Clearing House)  
KDPW\_CCP S.A.  
KELER CCP Ltd  
LCH.Clearnet Ltd  
LCH.Clearnet SA  
LME Clear  
Nasdaq Clearing  
National Clearing Centre (NCC)  
OMIClear  
Takasbank  
SIX x-clear AG  
Takasbank