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Sent by email to markt-h1-meetings@ec.europa.eu

31 March 2014

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

Dear Sirs and Madams

FIA Europe, the principal trade association in Europe for cleared derivatives with over 170 members, welcomes the opportunity to provide feedback on the Public Hearing on the Liquidity Coverage Requirement and the Leverage Ratio that you organised on 10 March 2014.

On 17 March 2014 a number of trade associations sent a letter to the Basel Committee on their revised Basel III Leverage Ratio framework and disclosure requirements that they had published in January 2014 (BCBS270 document). Having reviewed the EBA's Report on impact of differences in leverage ratio definitions and following the public hearing, we take this opportunity to reinforce some of the points raised in the attached letter sent to the Basel Committee and to highlight some of the areas of uncertainty of interpretation that remain outstanding, with a view to providing guidance of areas that would benefit from clarification in the European Commission's draft Delegated Act that is to be published pursuant to CRR Article 456(1)(j).

Our key recommendations are as follows:

(i) Criteria for netting of Securities Financing Transactions ("SFTs") cash receivables/payables with the same counterparty:

Not all SFTs have an explicit final settlement date: some are undated (e.g. "open" or "evergreen" repos). Such transactions should be treated as having a one-day maturity and the requirement that they have the same explicit final settlement date should be deemed to be met.

We recommend that paragraph 33(i)(b) of the BCBS270 paper clarify with respect to which counterparty the default, insolvency or bankruptcy should occur: counterparty, reporting entity or both? We consider that it should only cover the counterparty.

Paragraphs 12 and 13 of the Annex to the BCBS270 paper set out a number of requirements for qualifying master netting agreements, for the purposes of calculating the counterparty add-on of the exposure measure of SFTs.

We recommend the following clarifications be made in the draft Delegated Act:

- Specify which jurisdictions are the "relevant jurisdictions" in which the QMNA must be legally enforceable (see CRR Article 305(2)(c) for a potential approach).
- Most, if not all, CCPs have a right of last resort to close out some but not all of the open repo transactions when a clearing member defaults. This could automatically fall foul of "all transactions under the agreement" requirement in paragraph 12(a) of the Annex – we consider that clearing members should not be prevented from benefiting from the netting efficiencies simply because CCPs have such powers of last resort to mitigate and manage their own risks.

(ii) Criteria for allowing cash Variation Margin ("VM") received to be deducted from derivatives exposure value

In this regard, we attach a letter that our affiliate FIA, in conjunction with a number of other trade associations, sent to the Basel Committee earlier this month, seeking some further interpretation guidance on various points, including the criteria for cash VM to be deducted from the derivatives exposure value. In particular, we believe that, in client clearing transactions, the European Commission should exclude margin amounts collected by clearing member banks in excess of collateral amounts posted by the clearing member bank to the qualifying CCP (QCCP) *(typically in omnibus client segregated account structures*), since such excess amounts provide the clearing member bank with additional credit risk protection against the potential default of its client. This suggestion could be implemented by excluding such excess margin amounts entirely from the leverage ratio exposure measurement, or by instead reducing the bank's Potential Future Exposure (PFE) on client-facing derivatives by the amount of such excess collateral. Irrespective of the exact approach taken by the European Commission, we believe that the leverage framework, when finalized, should not impose capital penalties on banks that collect excess collateral from their clients, since this practice serves as an important form of credit risk management and in no way increases the bank's exposure.

In addition, we note the following:

Paragraph 25(ii)

There are certain categories of derivatives transactions where VM is exchanged on a regular basis, but not necessarily daily, for example options CCPs and energy CCPs.

Buyers of exchange-traded options do not receive VM from the options CCP. Instead, the options CCP 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 take a principles-based approach to implementing the daily VM requirement, by recognising that the key element is the exchange of VM payments on the shortest feasible cycle, rather than on a daily basis in all cases.

Paragraph 25(iii)

The BCBS270 leverage framework refers to the "currency of settlement," a concept which may result in confusion when applied to financial markets practice.

A strict interpretation would require GBP collateral to be posted for a GBP denominated trade, EUR collateral to be posted for an EUR denominated trade, etc.

That is not reflective of how master netting agreements (MNA) margining provisions tend to operate in practise. It is standard for the MNA to state that whilst the margin call will be expressed in a single currency, that margin call may be met by payment of cash denominated in one or more currencies specified in the MNA.

We strongly encourage the Commission to clarify that provided the cash collateral is paid in the currency(ies) specified in the MNA, this is sufficient to meet the requirements of Paragraph 25(iii), notwithstanding that such cash may be denominated in a different currency from one or more transactions that are subject to the MNA.

Paragraph 25(v)

We would welcome clarification in two areas:

- which jurisdictions should be considered to be "all relevant jurisdictions" – we assume (i) the jurisdiction whose bankruptcy law would apply upon the insolvency/bankruptcy of the counterparty and (ii) the governing law of the MNA;
- whether the second and third sentences in paragraph 25(v) refer to just close-out netting, or also to payment netting (i.e. right of set-off in the normal course of business).

Further, paragraph 25(v) mandates the MNAs to contain particular provision that the "counterparties agree to settle net any payment obligations covered by such MNA, taking into account any variation margin received or provided if a credit event occurs involving either counterparty". It is possible that MNAs do not explicitly stipulate this particular provision and we recommend that the Delegated Act avoids mandating the exact language that MNAs must include.

Conclusion

It is of the utmost importance that the European Commission's Delegated Act (i) clarifies the criteria for cash VM to be excluded from the derivatives exposures value and that the criteria are in line with the market practice and (ii) is precise and clear on the conditions that firms must fulfil in relation to different netting mechanisms applicable to the calculation of the derivatives and SFT exposure values.

We hope that you find these comments and the proposed interpretations helpful. We remain at your disposal should you wish to discuss these or any other issues relating to the new leverage rules.

Simon Puleston Jones
CEO
FIA Europe

Attachment:

A letter to the Basel Committee dated 17 March 2014 "Frequently asked questions in relation to BCBS 270 – Basel III Leverage Ratio framework and disclosure requirements" together with "Technical Recommendations – January 2014 BCBS Leverage Ratio"

FIA Europe's mission is to be the thought leader, advocate and educator connecting the centrally cleared derivatives industry. FIA Europe last year formed an affiliation with FIA under a new structure - FIA Global. Under this arrangement, FIA, FIA Europe and FIA Asia have strengthened their influence on cross-border issues, substantially increasing the coordination and information flow between regions and providing a powerful global voice to express the views of their members. The organisations preserve their ability to deal with legislative, regulatory and market issues in their respective time-zones and continue to operate with their own leadership and staff, separate boards of directors and distinct memberships.

March 17, 2014

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Re: Frequently asked questions in relation to BCBS 270 – Basel III Leverage Ratio framework and disclosure requirements

Dear Sirs and Madams:

The Global Financial Markets Association ("GFMA"), American Bankers Association, Financial Services Roundtable, Futures Industry Association, Institute of International Finance, the International Swaps and Derivatives Association, and The Clearing House, (collectively, "the Associations") represent the largest participants in national and global banking and financial markets.

The Associations support the Committee's efforts to impose a leverage ratio as a supplementary backstop measure to the risk-based measure and we appreciate this opportunity to provide feedback on the final leverage ratio framework in the form of frequently asked questions (FAQs). These FAQs deal with aspects of the proposals that have been raised with the Associations over the past two months and highlight the need for clarification of a number of material interpretation issues in the new rules. We believe that it is important for the BCBS to clarify how the rules should be interpreted at this stage especially to ensure that they are transposed correctly and consistently in national and regional implementation measures, without unintentional adverse impacts on the markets.

We continue to work actively with our members to identify any further issues that would benefit from clarification from the BCBS.

We hope that you find these questions and the proposed interpretations helpful and remain at your disposal should you wish to discuss these or any other issues relating to the new leverage rules.

Yours faithfully,

David Strongin Executive Director Global Financial Markets Association	Hugh Carney Senior Counsel American Bankers Association

Walt Lukken
President & Chief Executive Officer
Futures Industry Association

Richard Foster
Vice President & Senior Counsel for
Regulatory and Legal Affairs
Financial Services Roundtable

Mr. Kevin Nixon
Managing Director, Regulatory Affairs
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George Handjinicolaou, Ph.D
Deputy CEO and Head of ISDA Europe, Middle
East and Africa
International Swaps and Derivatives
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Brett Waxman
Senior Vice-President &
Associate General Counsel
The Clearing House

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.	Recommended Interpretation: 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.	Recommended Interpretation: 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.

25(iii)	The cash variation margin is received in the same currency as the currency of settlement of the derivative contract.	<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). 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. 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.

		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). 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). 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. 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

		organization's leverage exposure and would be inconsistent with market practices. 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. 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. 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

		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. The four examples at the end of this document illustrate the real world problems of applying the same-currency criterion on a narrower basis.
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.	Recommended Interpretation: 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.
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.	Recommended Interpretation: 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."
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.	Recommended Interpretation: 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

		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: "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: 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."
30	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: • 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	<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, *International Convergence of Capital Measurement and Capital Standards*, at 48, ¶ 193 (June 2006).

	to or greater than the remaining maturity of the written credit derivative.	
33(i)(a)	Transactions have the same explicit final settlement date.	Recommended Interpretation: 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	Recommended Interpretation: 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 and the linkages to collateral flows do not result in the unwinding of net cash settlement.[22]	Recommended Interpretation: 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

	[22]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.	therefore not be eligible) .
37 and footnote 25	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 *only* 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 [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).	Recommended interpretation: 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. 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.
Table 1 Line item 2	Adjustment for investments in banking, financial, insurance or commercial entities that are consolidated for accounting purposes but outside the scope of regulatory consolidation	Recommended interpretation: 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.
Annex par. 17 as related to par.38-39	Forward asset purchases, forward forward deposits and partly paid shares and securities, which represent commitments with certain drawdown, will receive a CCF of 100%	Recommended interpretation: 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

		conditions are met) plus the counterparty credit risk add-on. 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. 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. 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. 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

		treated as derivatives in the leverage exposure measure and not off-balance sheet items. In a similar vein, we believe that OTC equity forward purchases in the trading book will already be captured under the derivative exposure measure. 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.

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

<u>Example 2:</u>

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]} + €(1/3)*70 = €(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,[€50-€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.