

18 October 2013

Mr Wayne Byers
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel
Switzerland

Dear Mr Byers

Basel proposal to apply the higher leveraged capital requirement to client cleared derivatives

I am writing to draw your attention to a matter that has become an issue of critical concern to many of our members, namely, the proposal to apply the higher leverage capital requirement to client cleared derivatives. In this context, we have seen and support the letter sent to the Basel Secretariat (on 20 September) by the President and Chief Executive Officer of the Futures Industry Association.

The FOA (see *attached* information sheet) very much shares the substantive concerns raised in that letter which are founded on the fact that, for the reasons set out below, there is no apparent substantive risk-based need justifying the application of the leverage capital requirement to client cleared derivatives and that, in any event, its application will have significant adverse offsetting consequences.

1. The case for applying the leverage ratio to listed derivatives is driven by the need to cover market risk, the credit risk and the collateral risk flowing from rehypothecation, yet:
 - (a) clearing members have no market risk exposure generated by the derivatives positions of their clients;
 - (b) the risk calibration justifying the application of the leveraged capital requirement takes no account of the fact that counterparty credit risk exposure is already substantially mitigated through the application of initial margin and variation margin which has to be posted in the form of cash or highly liquid securities; and
 - (c) there are significant restrictions in place that limit the use of rehypothecation and therefore the risk flowing from that use.

2. The proposed application of the revised leverage capital requirement would, in effect, impose a double capital charge on client cleared derivatives insofar as it would apply to:
 - (a) the full value of the derivatives exposure without any offset for cash collateral; and
 - (b) the full value of the cash collateral actually received.
3. A key post-crisis objective was to enhance risk management capability, yet risk management costs are already the subject of substantial increases. The proposed leverage capital requirement would constitute yet another "pass through" cost to corporate and institutional customers and will further exacerbate the risk that either they may elect not to hedge their underlying positions (because of the increased cost of doing so) or, to the extent that they are permitted to do so, may decide to use bilateral, uncleared trades, which would run counter to the G20 mandate of incentivising the use of centrally cleared trades.
4. The impact of applying the proposed leveraged capital requirement to client cleared derivatives is exacerbated in the EU to the extent that market dealings do not take place on an agency basis, but on a principal-to-principal basis.

For these reasons, we believe that the risk assumptions supporting the application of the proposed leveraged capital requirement to client-cleared derivatives is deeply flawed and that it carries a real risk of serious unintended market consequences. We note, however, that the Basel Committee is conducting its own QIS on the impact of the proposed higher leverage capital framework.

If it is felt that the requirement should apply to client cleared derivatives, we would argue that it should only do so in relation to the client leg of the derivative, providing that it can be offset, as appropriate, against the mitigating impact of margin and netting and avoids any form of double counting risk.

In the usual way, if you would like to discuss these views further with the FOA, please do not hesitate to let me know.

Yours sincerely



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