



September 20, 2013

Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

Re: Revised Basel III Leverage Ratio Framework and Disclosure Requirements

Ladies and Gentlemen:

The Clearing House Association L.L.C. (“**The Clearing House**”),<sup>1</sup> appreciates the opportunity to comment on the Basel Committee on Banking Supervision’s (the “**Basel Committee**”) June 2013 consultative document entitled *Revised Basel III Leverage Ratio Framework and Disclosure Requirements* (the “**Consultative Document**”), and the revisions proposed therein (the “**Proposed Revisions**”). The Proposed Revisions address only certain aspects of the denominator of the Basel III leverage ratio (the “**supplementary leverage ratio**”), defined in the Consultative Document as the “**Exposure Measure**”, without addressing either the Exposure Measure more comprehensively or other components of the leverage ratio that ultimately determine its impact – most importantly, its calibration.

The Clearing House supports a leverage ratio as a “simple non-risk based ‘backstop’” to risk-based capital measures.<sup>2</sup> A properly-formulated leverage requirement supports the goals of safety and soundness by providing for significant resources to be available to absorb losses during periods of prolonged economic stress. The Proposed Revisions, however, raise three fundamental concerns.

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<sup>1</sup> Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world’s largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated clearing-house, funds transfer, and check-image payments made in the U.S. See The Clearing House’s web page at [www.theclearinghouse.org](http://www.theclearinghouse.org).

<sup>2</sup> Consultative Document ¶ 2.

First, taken together with initiatives by national regulators in some jurisdictions to apply a “super-equivalent” supplementary leverage ratio (that is, a ratio with a calibration higher than 3%)<sup>3</sup> to the banks they regulate, the supplementary leverage ratio (after giving effect to the Proposed Revisions) ultimately may act not as a backstop but instead as the binding constraint for many banks.<sup>4</sup> Such a result would not only be inconsistent with the Basel Committee’s stated objective but would also produce contrary financial and economic outcomes. And for some assets – particularly, low-risk ones – the combination of these initiatives for some banks would make the leverage ratio more binding than any risk-based measure, requiring affected banks to pull back from related business and/or raise related prices.

Second, the Proposed Revisions’ treatments of exposures arising from derivatives and from securities financing transactions (“SFTs”) substantially overstate the true risk, as quantified by more accurate and realistic measures of those exposures, and thereby create the potential for serious distortions. The banks most active in the derivatives and SFT markets are the global systemically important banks (“G-SIBs”), and G-SIBs are also those most likely to be subjected to a super-equivalent supplementary leverage ratio. An inaccurate, unrealistic and distortive treatment of derivatives or SFTs held by G-SIBs will inevitably affect not only these products directly – for example, the availability and cost of interest and foreign exchange swaps and contracts, both for banks and non-banks – but also (and perhaps even more importantly) indirectly through impacts on related markets, including markets for sovereign securities (which depend heavily on reverse repurchase agreements and repurchase agreements as a source of financing). In addition, if the leverage ratio becomes the binding constraint, banks may engage, especially in times of market stress, in deposit management to limit deposit inflows and prioritize deposits that do not adversely impact their liquidity ratios to help ensure compliance with leverage ratio and liquidity requirements. These actions could have adverse impacts on the financial sector and the economy more broadly.

Third, the Proposed Revisions’ approach to the Exposure Measure is too narrow. In order to make the supplementary leverage ratio a simple and credible backstop to risk-based measures, the Basel Committee should comprehensively revisit the calculation of the Exposure Measure and its components – particularly the treatment of off-balance sheet (“OBS”) commitments and unconditionally cancellable commitments – and not limit its review to derivative exposures and SFTs.

The Clearing House appreciates the importance of assisting the Basel Committee and national regulators by providing, where possible, quantitative analysis relevant to regulatory initiatives. For that

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<sup>3</sup> For example, in July 2013 the U.S. banking agencies approved for publication a notice of proposed rulemaking that would apply a 5% supplementary leverage ratio to U.S. bank holding companies having total consolidated assets of more than \$700 billion or assets under custody of more than \$10 trillion, and a 6% supplementary leverage ratio requirement to the depository institution subsidiaries of such holding companies for purposes of “well capitalized” qualification under prompt corrective action regulations. Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency, *Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions* (July 9, 2013) (the “U.S. Leverage Proposal”).

<sup>4</sup> We are using the term “banks” in this letter to mean any financial institution that may be subject to the supplementary leverage ratio, whether a holding company or a depository institution.

reason, The Clearing House has conducted a study, *Assessing the Supplementary Leverage Ratio* (“**The Clearing House Leverage Study**” or “**Study**”)<sup>5</sup> of the impact of the Proposed Revisions (and, where relevant, the U.S. Leverage Proposal) on the U.S. banking industry, products offered by U.S. banks, and U.S. markets. In addition, The Clearing House is participating in a joint study (the “**Global Leverage Ratio Study**” or the “**Global Study**”)<sup>6</sup> with the Global Financial Markets Association (“**GFMA**”) to assess the global impact of the Proposed Revisions on banks and on relevant product markets.<sup>7</sup> A copy of the Study is attached as Annex 1. The results of The Clearing House Leverage Study show that if the Proposed Revisions and the U.S. Leverage Proposal are both implemented, the U.S. advanced approaches banks would need \$202 billion<sup>8</sup> in additional Tier 1 capital or a reduction in exposures of \$3.7 trillion to be in compliance.<sup>9</sup> To meet the U.S. Leverage Proposal alone, the banks would need to raise \$69 billion in additional capital or reduce exposures by \$1.2 trillion.<sup>10</sup> Total exposures increase from \$11.7 trillion to \$16.4 trillion under the U.S. Leverage Proposal and to \$19.1 trillion under the Proposed Revisions (taking into account only the exposure measures without consideration of the banks’ compliance with the required minimum ratios).<sup>11</sup> These results demonstrate, among other things:

- for the eight U.S. banks that have been identified by the Financial Stability Board as G-SIBs,<sup>12</sup> the Proposed Revisions would result in the supplementary leverage ratio becoming the binding constraint for U.S. G-SIBs holding 67% of the aggregate total consolidated assets of those eight banks;
- the critical importance of considering the Proposed Revisions not in isolation but along with other initiatives – most importantly, super-equivalent proposals to increase the

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<sup>5</sup> The Study includes data that covers all U.S. G-SIB assets and approximately 93% of total assets of U.S. advanced approaches banks, which together comprise approximately 65% of overall U.S. industry assets (“**Sample Banks**”).

<sup>6</sup> The Global Study surveyed over 70% of the banking institution assets in North America, Europe, and Asia, including 15 G-SIBs.

<sup>7</sup> TCH is also conducting a study on the market impacts of the Proposed Revisions and the U.S. Leverage Proposal and the cumulative macroeconomic impacts of these and other regulations later this year.

<sup>8</sup> If the U.S. advanced approaches banks first raised the additional Tier 1 capital necessary to comply with the Basel III Framework’s risk-based capital rules on a fully phased-in basis (including the capital conservation buffer and G-SIB surcharges where applicable), those banks would still need to raise an additional \$185 billion of Tier 1 capital in order to be in compliance with the Proposed Revisions and the U.S. Leverage Proposal.

<sup>9</sup> In addition, in order for banks to maintain an average 50 to 200 basis point buffer above the minimum requirement, they would need to raise an additional \$273 billion to \$501 billion in additional Tier 1 capital.

<sup>10</sup> The Clearing House Leverage Study at 6.

<sup>11</sup> *Id.* at 4.

<sup>12</sup> The eight U.S. banks that the Financial Stability Board has identified as G-SIBs are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup, Inc., The Goldman Sachs Group, JPMorgan Chase & Co., Morgan Stanley, State Street Corporation and Wells Fargo & Company. See Financial Stability Board, *Update of Group of Global Systemically Important Banks (G-SIBs)* (Nov. 1, 2012).

calibration of the supplementary leverage ratio (including the U.S. Leverage Proposal); and

- the Proposed Revisions' potential for distortive consequences and impacts is particularly significant because it focuses on two asset classes and activities (derivatives and SFTs) in which the largest internationally active banks play the most important role. That should not be a deterrent to arriving at accurate and realistic measures of exposure for those asset classes and activities, but it does place a substantial premium on making sure that the Exposure Measures for those assets and activities are in fact accurate and realistic and do not overstate exposures so as to give rise to (i) distortions in decision-making or (ii) consequences and impacts on the markets for affected assets and exposures (e.g., interest rates, foreign exchange and sovereign securities) that would be most affected by an over-statement without those consequences and impacts first having been analyzed and understood.

Part I of this letter is an executive summary of our key recommendations and concerns with respect to the Proposed Revisions; Part II addresses our key concerns and recommendations in more detail; and Part III includes certain other comments.

#### I. Executive Summary

The Clearing House recognizes the critical role of a leverage ratio as a backstop to risk-based capital measures and supports the further refinement of this standard. However, the Proposed Revisions substantially overstate the measurement of derivative exposures and SFTs as components of the Exposure Measure, creating the potential for serious distortions in banks' decision-making as well as the markets for the financing and settlement of securities (particularly sovereign securities). We strongly believe the Basel Committee should reconsider its proposals and take additional steps before making any revisions to the supplementary leverage ratio. Specifically, we believe the Basel Committee should:

- Evaluate the cumulative effect of all potential changes to each of the components of the supplementary leverage ratio and incorporate the results of a quantitative impact study. The Proposed Revisions, taken together with other potential changes to the supplementary leverage ratio (including proposals to increase the calibration or narrow the scope of the numerator), threaten to turn the supplementary leverage ratio into a binding constraint rather than a backstop. The results of a comprehensive quantitative impact study ("QIS") that evaluates the total international impact of the Proposed Revisions alone and in conjunction with initiatives undertaken by national regulators should be taken into account in considering modifications to the supplementary leverage ratio.
- Revise the Proposed Revisions' treatment of derivative transactions and SFTs so that their inclusion as components of the Exposure Measure is accurate and realistic. Distorting contributions of particular assets or activities to the Exposure Measure inevitably will distort banks' fundamental business decisions, not only in ways that are

at cross purposes with other regulatory initiatives (for example, the Basel III liquidity framework's liquidity coverage ratio, or "LCR"<sup>13</sup> and net stable funding ratio,<sup>14</sup> the G-SIB surcharge,<sup>15</sup> requirements for increased margin – particularly initial margin – for cleared derivatives transactions,<sup>16</sup> loss absorbency requirements to facilitate resolutions,<sup>17</sup> and efforts to address vulnerabilities in short-term wholesale funding markets<sup>18</sup>), but also affecting what products banks make available to consumers and at what prices. Any consideration of the conservatism desired to be achieved through the supplementary leverage ratio to assure its proper functioning as a backstop to risk-based measures should be addressed through its calibration, not through distortions of components in its denominator. In particular, we strongly believe the supplementary leverage ratio should:

- In determining the Exposure Measure for derivative transactions, use a properly calibrated non-internal model method ("NIMM") that fully recognizes the benefit of collateral rather than the current exposure method ("CEM") which has widely recognized flaws, particularly as concerns recognition of netting and the benefits of collateral in determining potential future exposure ("PFE"). The Basel Committee's proposed NIMM provides a useful starting point for this calculation.<sup>19</sup>
- Subject to the standards described in Part II.B.2, include cash collateral for derivative transactions in the Exposure Measure on a net rather than a gross basis (that is, that banks may not reduce the Exposure Measure by any collateral they received and must gross up the Exposure Measure by collateral they provide). A gross treatment of cash collateral distorts a bank's actual derivative exposure, which is inconsistent with achieving an accurate and realistic Exposure Measure.

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<sup>13</sup> Basel Committee, Basel III: *The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January 2013) ("**Revised Basel III Liquidity Framework**").

<sup>14</sup> Basel Committee, Basel III: *International Framework for Liquidity Risk Measurement, Standards and Monitoring* (December 2010).

<sup>15</sup> Basel Committee, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013).

<sup>16</sup> See Part II.B.2 of this letter.

<sup>17</sup> See, e.g., Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big-to-Fail"—Report of the Financial Stability Board to the G-20* (September 2, 2013).

<sup>18</sup> See, e.g., Basel Committee, Consultative Document: *Liquidity Coverage Ratio Disclosure Standards* (July 2013) and Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* (August 29, 2013).

<sup>19</sup> Basel Committee, Consultative Document: *The Non-Internal Model Method for Capitalizing Counter-Party Credit Risk Exposures* (June 2013), available at <http://www.bis.org/publ/bcbs254.htm> ("**Basel NIMM Proposal**").

- At a minimum, cap exposure from a written credit derivative at the bank's maximum potential loss and recognize a wider range of hedging transactions, including offsetting for maturity mismatches and for a bank's purchased protection that is subordinate to its written protection.
- Subject to the standards described in Part II.B.4, permit offsetting SFT exposures that involve the transfer of loans or securities for cash on a net basis and eliminate the counterparty credit risk add-on. Again, offsetting provides a more accurate and realistic measure of exposure, and eliminating the add-on avoids double-counting.
- Exclude from the Exposure Measure SFTs on high quality sovereign securities held through SFTs. Failure to do so could, among other consequences, interfere with governments' implementation of monetary policy.
- Reconsider the calculation of exposure for all components of the Exposure Measure. Although all of the components of the Exposure Measure should be reevaluated and revised, as appropriate, based on the results of a QIS against the standard of determining accurate and realistic amounts for each type of exposure, changing the CCFs applied to OBS and unconditionally cancellable commitments to the Basel II<sup>20</sup> standardized approach's CCFs is most critical.
- Exclude central bank placements from the Exposure Measure. Banks may see an increase in client deposit activity as a result of macroeconomic factors or monetary policy decisions. This may have significant implications for banks' leverage ratios, particularly during periods of financial market stress. As central bank placements do not create further leverage within the financial system, it would be appropriate to exclude them from the Exposure Measure.
- Exclude exposures to central counterparties. Derivatives exposures arising out of transactions cleared through central counterparties ("**CCPs**") should be excluded from the Exposure Measure in light of regulatory changes mandating that all standardized over-the-counter ("**OTC**") derivative transactions are traded on exchanges or centrally cleared.
- Exclude assets that secure deposits of public sector entities from the Exposure Measure. Assets, such as U.S. government obligations securing deposits of Public Sector Entities ("**PSEs**"), should be excluded from the Exposure Measure. Banks must acquire and maintain such collateral, which will result in additional capital costs for banks that may be passed on to the PSEs if such collateral is included in the Exposure Measure.

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<sup>20</sup> Basel Committee, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework – Comprehensive Version* (June 2006) ("**Basel II**").

- Allow banks the flexibility to use daily data for purposes of calculating the Exposure Measure. Where available, a bank should be permitted to use the average of its daily data rather than month-end data when calculating the Exposure Measure.
- Tier 1 capital, rather than CET1, should remain the numerator for the supplementary leverage ratio. Tier 1 capital instruments are all loss-absorbing instruments and, therefore, it is not necessary to limit the numerator to CET1.

## II. Key Concerns and Recommendations

- A. The Proposed Revisions, taken together with proposals by national regulators and other initiatives, threaten to fundamentally shift the purpose and effect of the supplementary leverage ratio from a backstop to a binding constraint. Such a shift would also work at cross-purposes with other regulatory initiatives – particularly those addressing liquidity and margin requirements for counterparties to derivatives transactions – and potentially impact bank behavior and markets in unanticipated and adverse ways.**

As noted in the introductory paragraphs to this letter, The Clearing House supports the leverage ratio as a non-risk based backstop to risk-based capital measures. Changing in a meaningful way any one of the three components of the supplementary leverage ratio – that is, expanding the denominator (i.e., the Exposure Measure) as would the Proposed Revisions, increasing the calibration (as would the U.S. Leverage Proposal), or narrowing the scope of the numerator from Tier 1 capital to CET1 (a subject the Basel Committee has indicated it will continue to examine) – could have the impact of reversing the relationship between leverage and risk-based capital measures in a manner that causes the leverage ratio to be the binding constraint. Materially changing two or more of the components, as seems likely, only magnifies this concern and makes it essential that changes in the components be addressed (and their quantitative impact and consequences be considered) holistically and not in isolation.<sup>21</sup>

The Proposed Revisions' treatments of exposures arising from derivatives and SFTs substantially overstate accurate and realistic measures of those exposures and create the potential for serious distortions in banks' decision-making as well as the markets for the financing and settlement of securities (particularly sovereign securities). Those changes together with proposals of national regulators for a super-equivalent supplementary leverage ratio or other possible changes in the three components of the supplementary leverage ratio, substantially increase the likelihood that the supplementary leverage ratio will not be the binding constraint in only special circumstances, as would be expected for a true backstop measure, but would become the binding constraint for a substantial number of banks on an on-going basis. For example (and discussed further in Part II.B.5), for the U.S. G-SIBs, the Proposed Revisions and the U.S. Leverage Proposal, if both were adopted, would result in the supplementary leverage ratio becoming the binding constraint for U.S. G-SIBs holding 67% of the aggregate total consolidated assets of those eight banks. A leverage ratio that becomes binding for a substantial number of covered institutions would turn the intended relationship between risk-based requirements and the leverage requirement on its head. As a result, it may lead banks to take actions that contribute to systemic risk because, among other things, it could:

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<sup>21</sup> See notes 3 and 4.

- penalize banks for holding high quality liquid assets of the type required by the LCR, (i) cutting directly against the imperative of addressing liquidity risk as a threat to banks and markets that is at least as important as addressing the risk of insufficient capital and (ii) if banks respond to that penalty by holding a lesser amount of high quality liquid assets than they otherwise would, inevitably increasing risks for those banks and the financial system in times of stress;
- make it substantially more costly for banks to comply with increased margin requirements – particularly, initial margin – for cleared and uncleared derivatives transactions;<sup>22</sup>
- discourage banks from holding excess reserves that facilitate global payment and settlement systems;
- punish low-risk business activities that are liability driven – for example, trust, custody and safekeeping activities; and
- incentivize banks to hold more assets that are higher risk and produce greater returns than assets that are lower risk and produce lower returns, counter to sound management practices and regulatory objectives.

Additionally, by focusing on derivatives and SFTs, which play critical roles in financial markets (including the settlement of securities trades) and particularly sovereign securities markets, the Proposed Revisions, if adopted, would have perhaps far-reaching but under-appreciated impacts on the functioning of markets, especially for sovereign debt securities typically financed in the repo market, and the broader financial system. The Clearing House Leverage Study shows that the Proposed Revisions' changes in the calculation of the Exposure Measures for derivatives and SFTs of the eight U.S. G-SIBs would increase their aggregate Exposure Measures by \$2.7 trillion to \$19.1 trillion (compared to an aggregate Exposure Measure for those banks of \$13.6 trillion for the supplementary leverage ratio as calculated under the Basel III Framework<sup>23</sup> without giving effect to the Proposed Revisions).

The basic conceptual deficiencies of leverage as a capital measure have long been recognized by the Basel Committee and national regulators. It is a blunt and indiscriminate tool that, by starting with the accounting measure and not adjusting for (indeed, ignoring) relative risk in a bank's balance sheet or operations, fails to calibrate the amount of required capital to risk. The Basel Committee's recognition of the basic deficiencies in a simple leverage approach to capital was its motivation for adopting risk-based measures. The Basel Committee commented, in explaining the use of risk weightings in its initial 1988 accord, that "a weighted risk ratio in which capital is related to different categories of asset or off-balance sheet exposure, weighted according to broad categories of relative riskiness, is the preferred method for calculating the capital adequacy of banks."<sup>24</sup> The Basel Committee went on to note, as an

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<sup>22</sup> See Part II.B.2.

<sup>23</sup> Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, revised June 2011) ("**Basel III Framework**").

<sup>24</sup> Basel Committee, *International Convergence of Capital Measurement and Standards* (July 1988), ¶ 28.



advantage of a risk-based measure, that “it does not deter banks from holding liquid or other assets which carry low risk.”<sup>25</sup>

The implementation deficiencies in risk-based measures and the downside of relying solely on those measures have become apparent since the initial 1988 accord, most notably during the recent financial crisis and with respect to certain asset classes (e.g., mortgages, securitizations and correlation trading positions). Although we continue to believe strongly that implementation of a risk-based approach to capital overall is the correct and more sound approach, the financial crisis showed that a risk-based approach in certain circumstances may fail accurately to recognize and measure risk, making the utility of a backstop measure apparent. This may be true for relatively new financial products that have been untested through economic cycles and for periods of extraordinary financial stress. The Basel Committee noted as its rationale and objective, using identical language both in proposing and adopting releases, that “[i]n many cases, banks built up excessive leverage while still showing strong risk based capital ratios.”<sup>26</sup> Senior regulators have emphasized the point on numerous recent occasions.<sup>27</sup>

The conceptual underpinning for a leverage ratio as a backstop to risk-weighted measures is to address the potential that, notwithstanding regulators’ and banks’ best efforts, and notwithstanding the substantial increases in required risk-based capital under the Basel III Framework (including after taking into account buffers and surcharges) as compared to pre-crisis standards, risk-weightings may not always appropriately capture risk. As noted above, The Clearing House continues to support a leverage measure as a backstop, including a properly formulated and calibrated supplementary leverage ratio. However, it is exceedingly important that the supplementary leverage ratio, as intended, function as a backstop and not the binding constraint. The difference between national regulators’ ability to remedy recognized deficiencies in leverage and risk-based capital measures should be indisputable. The fundamental deficiencies in a leverage measure cannot be fixed – that is, the risk-insensitive and distortive impact of an undifferentiated denominator is inherent in a leverage ratio. In contrast, in the event that the risk-weightings used in risk-based measures may as to some asset classes be proven to under-weight or over-weight risks, whether generally or at points in time, those mis-calibrations can be recognized and addressed.

Finally, we are deeply concerned that the interaction of the suite of pending rules, both in the United States and internationally (e.g., leverage, capital, liquidity and debt-related requirements), are not well understood and may in fact lead to incentives that increase risk in the system as banks seek to optimize their capital structures and asset mixes across these different requirements. In implementing these rules, it is exceedingly important that the Basel Committee and national regulators adopt a

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<sup>25</sup> *Id.*

<sup>26</sup> Basel Committee, *Consultative Document: Strengthening the Resilience of the Banking Sector (“2009 Basel III Proposed Framework”)* (Dec. 2009) ¶ 202; Basel III Framework ¶ 151.

<sup>27</sup> E.g., comments of Paul Tucker, Deputy Governor, Bank of England at a press conference following the meeting of the Bank of England’s Financial Policy Committee (June 26, 2013) (leverage ratio is “there as a backstop because the current risk weights in Basel II allowed financial institutions to become incredibly levered . . .”); Daniel K. Tarullo, Member of the Board of Governors of the Federal Reserve System, in testimony before the U.S. House of Representatives’ Committee on Financial Services (June 26, 2011) (“In this regard, the international leverage ratio the Basel Committee has adopted and is currently monitoring serves as an important backstop to risk-based ratios that rely extensively on banks’ models”).

comprehensive and holistic approach in determining required thresholds, with a view to ensuring that incentives are not distorted when these requirements are viewed together and that stated goals of simplicity and transparency can be met.

After releasing the 2009 Basel III Proposed Framework, the Basel Committee commenced a QIS and, in December 2010, published that QIS contemporaneously with its release of the final Basel III Framework. The 2010 QIS's discussion of leverage was limited, noting that the average leverage ratio for Group 1 banks (those with Tier 1 capital in excess of €3 billion and that are well diversified and internationally active) was 2.8% and Group 2 banks (which was defined as all other banks) was 3.8%.<sup>28</sup> The Consultative Document does not address whether the Basel Committee has undertaken a QIS of the impact of the Proposed Revisions or, if it has, what that analysis shows. We believe it is essential that it do so; no revisions should be made to the supplementary leverage ratio as formulated in the Basel III Framework until results of a comprehensive QIS are made public and considered. Moreover, the results of the QIS may require substantial changes to the Proposed Revisions as set forth in the Consultative Document and, potentially, publication of revised proposals for additional comment. The substantial impact on the Exposure Measure of the Proposed Revisions' two principal changes in the supplementary leverage ratio – the treatment of derivative transactions and SFTs – makes this essential. The Clearing House Leverage Study and the Global Leverage Study, we anticipate, will contribute to a better understanding of the Proposed Revisions' impact. But it will be very important that the results of a more comprehensive QIS focused not only on our participating banks, but on the broader international impact, be considered.

- B. The Clearing House agrees with the underlying premise that the Exposure Measure should not differ for banks depending upon the applicable accounting regime – U.S. generally accepted accounting principles (“U.S. GAAP”) or international financial reporting standards (“IFRS”). However, we strongly believe that the Basel Committee should not simply default to the regime that applies the broadest Exposure Measure by effectively using a gross treatment but instead should adopt a principles-based approach, apart from accounting standards and recognizing the special circumstances of derivative exposures and SFTs, that permits netting and collateral recognition consistent with an accurate and realistic measure of those exposures.**

The Basel III Framework adopted the accounting measure of exposure for both derivatives and SFTs but qualified the accounting measure by making the Exposure Measure calculations subject to Basel II's regulatory netting rules (excepting the rules for cross-product netting),<sup>29</sup> largely because the offsetting and cash collateral recognition rules under U.S. GAAP and IFRS differ. The Basel Committee notes in the Consultative Document the most important differences between U.S. GAAP's and IFRS's treatment of derivatives and SFTs, with U.S. GAAP generally favoring netting and IFRS generally favoring a gross presentation.<sup>30</sup>

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<sup>28</sup> Basel Committee, *Results of the Comprehensive Quantitative Impact Study* (December 2010) ¶ 5.

<sup>29</sup> Consultative Document ¶¶ 159-161.

<sup>30</sup> For example:

(continued...)

We support the Basel Committee's objective of establishing a uniform Exposure Measure for purposes of the supplementary leverage ratio. It is exceedingly important, however, that the Basel Committee, in standardizing the Exposure Measure of derivative transactions and SFTs for a leverage ratio that in most respects primarily relies on accounting measures, approach the task with a focus on how best to measure the exposures in light of the relative and absolute risks of the underlying positions and NOT as a choice between one accounting measure or another (*i.e.*, not a decision as to whether U.S. GAAP or IFRS is "better").

Although the Proposed Revisions purport to preserve the Basel III Framework's incorporation of netting as a matter of principle, they effectively undermine this result in practice. First, with respect to derivatives, by defaulting to the Basel II standardized approach's CEM as the starting point, with its replacement cost ("RC") plus PFE add-on, the Basel Committee has incorporated into the supplementary leverage ratio's Exposure Measure all of the well understood and much discussed limitations of CEM in its current form, including the PFE's overstatement of exposure resulting from its limits on the degree to which the economic benefits of legally enforceable netting arrangements may be taken into account and its limited recognition of collateral. The failure to reflect the full effect of derivative netting arrangements is further exacerbated by the Proposed Revisions' punitive treatment of collateral received or provided to secure such transactions. Second, in the context of both derivatives and SFTs, we do not believe that the gross measurement approach taken by the Proposed Revisions produces the most accurate and realistic measure of exposure and, consequently, is not the appropriate approach for determining total assets for inclusion in the Exposure Measure (and hence, the potential for leverage).

#### 1. Derivative Transactions – CEM.

The limitations of CEM are readily apparent. CEM grossly overstates any realistic economic measure of exposure, with the overstatement driven mostly by the calculation of PFE. Under CEM, the

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(...continued)

- their treatments of cash pledged to counterparties to secure derivative liabilities differ, in that (i) under U.S. GAAP there is a reduction in total assets if the appropriate standards for netting are met (including a legally enforceable master netting agreement) and (ii) under IFRS there is no impact on total assets;
- their treatments of cash collateral received from counterparties to secure derivative assets differ, in that (i) under U.S. GAAP the liability recorded (*i.e.*, to return the cash) is offset against the related derivative asset if the appropriate standards for netting are met, with the consequence that there is no increase in the balance sheet's total footings, and (ii) under IFRS the liability record (to return cash) is not offset against the related derivative asset (resulting in an increase in total assets); and
- their treatments of repurchase and reverse repurchase agreements (and, for that matter although less customary, securities borrowing and lending transactions with defined maturity dates) differ when securities are loaned or exchanged for cash as opposed to for other securities, with U.S. GAAP permitting netting where specified conditions are met whereas IFRS generally requires a gross presentation.

For a discussion of the differences between U.S. GAAP's and IFRS' treatments of netting and offsetting, see International Swaps and Derivatives Association, Inc., *Netting and Offsetting: Reporting Derivatives Under U.S. GAAP and Under IFRS* (May 2012).

PFE calculation recognizes netting on only 60% of the netting set, even though the transactions are subject to a qualifying master netting agreement meeting Basel II standards. In addition, the PFE does not include collateral that would be posted against future exposures.<sup>31</sup>

The Basel Committee and national regulators understand those limitations and are considering alternatives to address them – most notably, the Basel NIMM Proposal as an alternative for the CEM. Although more risk sensitive, the Basel NIMM Proposal continues to overstate or misstate risk, for example by scaling the notional amount of interest rate swaps by maturity, using overly simplistic supervisory delta adjustments to reflect the direction of a transaction and its non-linearity and providing only limited recognition of collateral. In addition, the Basel NIMM Proposal is very conservatively calibrated, as reflected in the alpha of 1.4 that is applied to the expected exposure. Notwithstanding these and other drawbacks of the Basel NIMM Proposal, we believe that conceptually NIMM is a meaningful step forward from CEM and that its underlying principles and assumptions, which give broader recognition to Basel II netting and give some credit for collateral (including variation margin), may serve as the foundation for an appropriate approach to calculating exposures arising from derivative transactions for purposes of the supplementary leverage ratio. If a NIMM-based approach is used for leverage purposes, however, it will be very important that the approach incorporate substantially more complete collateral recognition than the Basel NIMM Proposal as proposed. We believe that an appropriately calibrated NIMM that fully recognizes the benefit of collateral would be an appropriate method to calculate the exposure.

## 2. Derivative Transactions – Cash Collateral Received and Provided.

As noted above, the existing Basel III Framework includes derivatives in the supplementary leverage ratio's denominator based on the accounting measure of exposure, subject to regulatory netting rules based on Basel II (but excepting the rules for cross-product netting).

By comparison, in addition to the incorporation of CEM as the beginning point for the treatment of derivatives, the major difference between the Proposed Revisions' and the Basel III Framework's treatment of derivative transactions is with respect to the treatment of collateral. The Proposed Revisions require that banks not reduce their Exposure Measure by any collateral received and that they gross up their Exposure Measure by the amount of collateral provided.<sup>32</sup> The impact of these proposed changes is most significant as applied to the treatment of cash collateral received or provided. Unlike other collateral, cash collateral that a bank receives in a derivatives transaction is included as an asset on its balance sheet and therefore would be included in the Exposure Measure of that institution in addition to the derivatives exposure collateralized by the cash. This could lead banks to prefer non-cash collateral (or no collateral) to cash collateral, which would be in direct tension with proper risk management.

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<sup>31</sup> For a discussion of the limitations of CEM, see letter from TCH, the American Bankers Association, the Financial Services Forum, The Financial Services Roundtable, and the Securities Industry and Financial Markets Association to the Board of Governors of the Federal Reserve System regarding Enhanced Prudential Standards and Early Remediation Regulations under Dodd-Frank 165/166 dated April 27, 2012 ("**Associations' Section 165 Comment Letter**"), and "Single Counterparty Credit Limits: The Clearing House Industry Study" dated July 2012 ("**The Clearing House SCCL Study**").

<sup>32</sup> Consultative Document ¶¶ 27-28.

We strongly believe that neither provision should be applied to cash collateral when the following criteria are satisfied:

- the counterparties intend to settle net if a credit event (e.g., bankruptcy or insolvency or a default) occurs as to either counterparty;
- in the case of cash collateral received, the receiving bank's right to offset the cash collateral it holds against the counterparty's payment obligation is legally enforceable pursuant to a master netting agreement, including in the event of the counterparty's bankruptcy or insolvency; and
- in the case of cash collateral provided, the providing bank's right to offset the cash collateral against its payment obligation in favor of the counterparty is legally enforceable pursuant to a master netting agreement, including in the event of the counterparty's bankruptcy or insolvency.

Provided that the foregoing elements are satisfied, requiring that cash collateral received or provided not be recognized – meaning, effectively, a gross presentation insofar as collateral is concerned – elevates form over substance. Although it is true that in some jurisdictions<sup>33</sup> parties providing or receiving cash collateral customarily settle on a gross basis and offset the cash collateral received or provided only if a credit event occurs with respect to a counterparty, the real exposure for the bank – that is, the amount that should be captured as part of the Exposure Measure – is the amount of the bank's remaining claim after the offset for cash collateral, provided that the offset for cash collateral is legally enforceable. The International Swaps and Derivatives Association, Inc. (“ISDA”) has obtained opinions in 55 jurisdictions confirming the enforceability of the master netting agreements customarily entered into between counterparties to derivatives transactions. The industry has relied upon these opinions, and evidence shows that they have done so properly. We are aware of no circumstance where a court addressing the enforceability of netting in a jurisdiction covered by one of these opinions has concluded that a netting agreement is not enforceable under local law.<sup>34</sup> Requiring a gross treatment for cash collateral received or provided distorts banks' derivatives exposures and runs directly counter to the standard of choosing a presentation that provides an accurate and realistic measure.

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<sup>33</sup> In U.S. markets, for example, the customary practice for settling derivatives absent the occurrence of a credit event (e.g., bankruptcy or insolvency or default), mostly as a matter of simple history and market practice, is gross settlement – that is, although the counterparties have entered into a master netting agreement that permits offsetting if a credit event occurs with respect to a counterparty, both counterparties transfer money, notwithstanding that after giving effect to multiple payments the parties are in the same position they would have been in had a settlement amount been calculated and only the party having a payment obligation on a net basis had transferred money. If a credit event occurs, then the parties settle on a net basis.

<sup>34</sup> Master netting agreements have proven enforceable even during periods of extreme stress. For example, the bankruptcy of Lehman Brothers did not impact the enforceability of close-out netting provisions of the ISDA master netting agreement. See Letter, dated Nov. 15, 2010, from ISDA to the Financial Accounting Standards Board commenting on the Offsetting of Derivatives Assets and Liabilities at 8.

Moreover, a large proportion of derivative transactions are between dealers. The Basel Committee, in considering the treatment of collateral, should take into account initiatives designed to enhance the robustness of the inter-dealer market pursuant to a series of G-20 mandates.<sup>35</sup> They include, most importantly, "...requirements for standardized OTC derivatives to be cleared through central counterparties (CCPs), requirements for collateral to be posted against both current and potential future counterparty exposures, whether centrally cleared or non-centrally cleared, and requirements that banks hold additional capital against their uncollateralized derivative exposures."<sup>36</sup> As the Macroeconomic Assessment Group on Derivatives has observed, "[w]hile these reforms have clear benefits, they do entail costs."<sup>37</sup> In particular:

- The Basel Committee and the Board of the International Organization of Securities Commissions ("**IOSCO**") released earlier this month their final policy framework establishing minimum standards for margin requirements for non-centrally cleared (i.e., OTC) derivatives.<sup>38</sup> That framework addresses both initial and variation margin, with the increases in required initial margin as compared to market practice being most significant; and
- National regulators in many jurisdictions, including the United States,<sup>39</sup> are moving ahead with regulations addressing initial and variation margin requirements for uncleared OTC derivatives as well as cleared OTC and exchange-traded derivatives.

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<sup>35</sup> G20, *Leaders' Statement: The Pittsburgh Summit* (Sept. 24-25, 2009) at 9; G20, *Cannes Final Summit Declaration, "Building Our Common Future: Reviewed Collective Actions for the Benefit of All"* (draft No. 4, 2011), ¶ 24. The Financial Stability Board noted in a recent report that the G20 countries have already made significant progress toward implementing these policy goals, with over half of the Financial Stability Board member jurisdictions having legislative frameworks in place with respect to these matters, and the jurisdictions with the largest derivatives markets have implemented concrete rules regarding central clearing requirements. Financial Stability Board, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of Financial Stability Board to G20 Leaders* (Sept. 5, 2013).

<sup>36</sup> Macroeconomic Assessment Group on Derivatives, *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms* (August 2013).

<sup>37</sup> *Id.*

<sup>38</sup> Basel Committee and Board of IOSCO, *Margin Requirements for Non-Centrally Cleared Derivatives* (September 2013) (the "**Basel/IOSCO Non-CCP Final Framework**").

<sup>39</sup> Title VII of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act requires that certain categories of derivatives be cleared through regulated clearing houses, subject to the margin requirements of each clearing house, and that uncleared derivatives be subject to margin requirements established by the Commodity Futures Trading Commission ("**CFTC**") and other prudential regulators in the United States. Pursuant to this authority, the CFTC and the bank prudential regulators have each proposed rules governing margin on uncleared swaps entered into by swap dealers, and the CFTC has adopted rules as part of its "core principles" for derivatives clearing organizations governing margin on cleared swaps. *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (April 28, 2011); *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27654 (May 11, 2011); CFTC Rule 39.13.

These reforms will require parties to standardized derivatives that must be cleared through CCPs to post substantial initial and variation margin collateral in the form of cash or other liquid, high quality assets. Similarly, under the Basel/IOSCO Non-CCP Final Framework for derivatives that are not centrally cleared, dealers and other financial firms “must exchange initial and variation margin as appropriate to the counterparty risks covered by such transactions,”<sup>40</sup> again in the form of cash or liquid high quality assets. Taken collectively, these initiatives will require banks, and especially those banks that act as dealers in the OTC derivatives market, both to pledge and collect significantly greater amounts of collateral with respect to derivatives. Giving no collateral netting recognition under the Exposure Measure runs directly contrary to those initiatives.

### 3. Written Credit Derivatives.

The Proposed Revisions would add an additional component for written credit derivatives, reverting to the initial 2009 Basel III Proposed Framework’s proposal that the notional amount of written credit derivatives be included in the denominator of the supplementary leverage ratio (but, in 2009, unlike the Proposed Revisions, without also including a component for RC). The Proposed Revisions permit banks to offset credit derivatives written by the amount of credit derivatives purchased “on the same reference name and level of seniority if the remaining maturity of the purchased credit derivative is equal to or greater than the remaining maturity of the written credit derivative.”<sup>41</sup>

As a conceptual matter, the exposure amount for credit derivatives is the same as the exposure amount for other derivatives: RC and PFE. In our view written credit derivatives should not be singled out for disparate treatment as there is no sound analytic basis for doing so. And in any event, written credit derivatives should not be subject to overlapping standards, with a contribution to the Exposure Measure both under the general RC and PFE provisions applicable to all derivative exposures and with a notional amount add-on for written credit derivatives. Measurement of the exposure arising from written credit derivatives under both the RC component of the general provisions and the notional amount add-on both capture credit exposure to the reference entity (using a broader and more blunt approach in the case of the notional amount add-on), double counting the bank’s exposure to the underlying reference obligors.<sup>42</sup>

Moreover, the Exposure Measure should be capped at the maximum potential loss a bank would face. The approach taken in the Proposed Revisions may result in an Exposure Measure that exceeds that maximum potential loss. Specifically, because the Proposed Revisions require the inclusion of both the full notional value of a written credit derivative and a gross-up for collateral that the bank has posted, a written credit derivative often will be included at an amount greater than its full notional value. For an example of the Proposed Revisions as applied to written credit derivatives, see Example 1 in Annex 2.

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<sup>40</sup> Basel/IOSCO Non-CCP Final Framework at 9.

<sup>41</sup> Consultative Document ¶ 31.

<sup>42</sup> See the Associations’ Section 165 Comment Letter and The Clearing House SCCL Study for a description of the effect of double-counting exposure from credit derivatives.

We also urge the Basel Committee to reconsider the degree to which offsetting is permitted. As noted above, under the Proposed Revisions, the ability to offset is available only if the purchased credit derivative is at the same level of seniority and has a maturity equal to or greater than the remaining maturity of the written credit derivative. We believe permitting offsetting in a wider range of circumstances is appropriate and more reflective of a realistic and accurate measure of exposure. In particular:

- Offsetting where there is a mismatch in maturity should be permitted. As a general matter, hedges with maturity mismatches should be recognized to the same extent as under the risk-based capital framework—that is, they should be recognized when their original maturities are greater than or equal to one year and have a residual maturity of at least three months.<sup>43</sup> If the approach from the risk-based capital framework is not used, we propose that the Basel Committee permit offsetting on a proportional basis. This would be appropriate because, for example, if a bank as protection provider enters into a credit default swap (“CDS”) having a remaining maturity of one year and as a credit protection purchaser enters into a CDS on the same reference name and with the same level of seniority having a remaining maturity of nine months, there can be no question but that the bank has hedged its exposure at least in part. Specifically, we propose that for a single reference entity, all trades with identical maturities would first be fully netted. The proportion of remaining gross written protection that is included in the Exposure Measure would be the ratio of the sum of the maturity weighted notional at each maturity divided by the sum of the maturity weighted “gross” written protection. The calculation expressed as a formula and a numerical example are included in Annex 2, Example 2.
- Subordinate protection should be recognized as a hedge for senior protection. Subordinate protection purchased by a bank should be permitted to offset more senior protection written by the bank.<sup>44</sup> If a bank purchases subordinate protection to hedge more senior written protection, there is no default scenario under which the bank would have an exposure despite the mismatch in seniority because of the methodology for determining payment amounts under credit derivatives. As an initial matter, a credit event is triggered under all credit derivative contracts in a netting set regardless of seniority. The recovery values are then established by auction, with a senior auction that covers only senior bonds, and a subordinate auction that includes both senior and subordinated bonds. Because the recovery value on the more senior protection will be higher than on the subordinate protection, the bank’s associated or its written credit protection (that is, the difference between the notional amount and the recovery value) will necessarily be lower than the payment it will receive on its purchased credit protection.

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<sup>43</sup> Basel II ¶204.

<sup>44</sup> This would be consistent with the similar approach taken in, Basel Committee, *Consultative Document: Supervisory Framework for Measuring and Controlling Large Bank Exposures* (March 2013) (the “**LE Consultative Document**”) ¶ 91.



- Subordinate tranches should offset more senior tranches of the same index. Again because of the payment structure, protection a bank purchases on a subset of a pool should be permitted to hedge more senior protection the bank has written on an identical subset of a pool on a one-for-one, or notional-for-notional, basis. The subordinate tranche takes losses at the same time or earlier than the senior tranches and is fully eliminated at the same point or earlier than the senior tranches. As a result, the recovery amount of the subordinate tranche will be lower and the pay-out higher than the bank's more senior written protection as a separate exposure.

In addition, in keeping with the goal of obtaining a more accurate and realistic measure of exposure, we propose two additional changes to the treatment of credit derivatives. First, each reference name within a non-tranched credit index should be treated as a separate exposure. This treatment would be consistent with the treatment of underlying reference names in a non-tranched credit index under a legally enforceable netting arrangement—that is, the protection writer must take the defaulting reference name out of the index and treat the exposure identically to how it treats credit protection that it has written on the reference name outside of the index. Second, if written credit derivatives are treated differently than other derivatives because they create a notional credit exposure based on the creditworthiness of the reference entity, credit protection purchased to offset that credit exposure (i.e., CDS and total return swaps) also should be recognized. Accordingly, exposures under bonds or other loans should be offset by protection purchased on the same reference name as the issuer or guarantor of the bonds or loans and at the same level of seniority (or more subordinated). This treatment would reflect the reality that bonds, loans, and credit derivatives are all part of a contractually binding netting set, and, in the event of default, bonds or loans that are issued or guaranteed by the reference entity and not senior to the credit protection are deliverable into the credit derivative.

4. Securities Financing Transactions.

a. *Offsetting of SFT exposures*

As noted above, the existing Basel III Framework includes SFTs in the supplementary leverage ratio's denominator based on the accounting measure of exposure, subject to Basel II's regulatory netting rules (but excepting the rules for cross-product netting). The Proposed Revisions would deviate from an accounting measure of exposure by calculating the Exposure Measure for SFTs as the sum of gross SFTs recognized for accounting purposes (with no recognition of accounting netting) plus a measure of counter-party credit risk calculated as current exposure without an add-on for potential future exposure. The Clearing House Leverage Study indicates that, for U.S. advanced approaches banks,<sup>45</sup> the Proposed Revisions' change in the treatment of SFTs would increase their aggregate Exposure Measure by \$700 billion.

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<sup>45</sup> The term "**U.S. advanced approaches banks**" means U.S. banks that have either \$250 billion or more in total consolidated assets or \$10 billion or more in foreign exposures. The U.S. banking agencies' capital rules require those banks to calculate risk-based capital applying the agencies' version of the Basel II advanced approaches as well as, as a result of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the general risk-based capital rules (with the more restrictive of the two calculations being binding). The Clearing House Leverage Study used U.S. banks having \$200 billion or more in total

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The Clearing House respectfully disagrees with the Proposed Framework's treatment of SFT netting arrangements. The Basel Committee proposes to measure SFT assets on a gross basis, with no recognition of accounting netting, noting that "this regulatory treatment is prudent and has the additional benefit of avoiding inconsistencies from netting which may arise across different accounting regimes."<sup>46</sup>

The Clearing House believes that the Basel Committee's two cited reasons for the proposed treatment of SFTs – prudence and accounting consistency – would be better advanced by recognizing SFT netting arrangements that meet rigorous, internationally uniform enforceability standards. This approach would solve the problem of perceived inconsistent outcomes driven by potentially inconsistent accounting frameworks while ensuring that SFT exposures are measured on a consistent and appropriate basis. Prudent supervision demands that leverage exposure measurements reflect legal and economic realities; an exposure measurement that crudely under- or over-reports exposures is an unreliable approach to setting regulatory capital requirements.

As discussed in the introductory paragraphs of this Part II.B, it is exceedingly important that the Basel Committee's approach to SFTs, like derivatives, focus on identifying the appropriate measure of exposure in light of the relative and absolute risks of the underlying positions. As in the case of the treatment of collateral and derivatives transactions, not permitting an offset for settlement of SFTs that are exchanges of securities for cash elevates form over substance. We strongly believe that the supplementary leverage ratio should permit banks, in the case of repo transactions and other SFTs that involve the transfer of loans or securities for cash (as opposed to for other securities), to measure exposures on a net basis by counterparty (e.g., offsetting repurchase agreements and securities loans against reverse repurchase agreements with the same counterparty and maturity) when the following criteria are satisfied:

- the transactions are with the same counterparty (either explicitly required or necessary to meet other netting criteria);
- the transactions have the same explicit maturity;
- the bank's right to offset the amount it owes the counterparty with the amount owed by the counterparty is legally enforceable; and
- the counterparties intend to settle net if a credit event occurs as to either counterparty, settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement.<sup>47</sup>

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consolidated assets as a proxy for U.S. advanced approaches banks in order to adjust for the possibility that some banks may voluntarily apply the advanced approaches notwithstanding that they are not required to (generally because those banks are owned by non-U.S. banks that do apply advanced approaches).

<sup>46</sup> Proposed Revisions ¶35(i) and note 20.

<sup>47</sup> Many transactions settle through central settlement systems ("CSS") that only have the functionality to settle on what is technically a gross basis. The CSS, however, typically requires a single net payment daily because  
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These elements provide a single standard for ensuring that SFT positions will be netted under common economic principles. Where a bank has offsetting positions that meet these netting criteria, there is no economic risk exposure. The Basel Committee recognizes this principle elsewhere in the Proposed Revisions, such as where the Committee permits a bank to reduce its measure of written CDS exposures where it has offsetting short positions. Likewise, the Proposed Revisions recognize that a bank's derivatives PFE measurement will reflect netted and offsetting positions in some cases. It would be conceptually inconsistent with other principles of exposure measurement in the Proposed Revisions – and with the underlying goal of actually identifying an accurate and realistic measurement of bank's SFT exposures – to disregard netting arrangements that are applied uniformly and consistently to all internationally active banks. For an example of the Proposed Revisions as applied to SFTs, see Example 3 in Annex 2.

The netting elements described provide a rigorous, reliable and tested standard for SFT netting recognition. These elements are common to both major accounting frameworks and provide a consistent regulatory standard for ensuring that the measurement of SFT positions appropriately considers a bank's legally enforceable right to set-off. IFRS and U.S. GAAP do not significantly diverge on the balance sheet presentation of SFTs when considering the International Accounting Standards Board's amendments to clarify that the use of some securities settlement systems may be considered equivalent to net settlement. Thus, our recommended changes to the Proposed Revisions broadly align with IFRS and U.S. GAAP netting guidelines for SFTs. Based on this and consistent with regulatory objectives to encourage such safe business practices, we believe it is appropriate to recognize such netting in the determination of the exposure amount for leverage purposes.

Moreover, we do not support (or even understand the logic of) the Proposed Revisions' requirement that a current exposure amount be added to an SFT's gross amount in the case of SFTs that involve the loan or exchange of securities for cash.<sup>48</sup> If banks are required to begin the Exposure Measure calculation for SFTs by including gross SFT assets recognized for accounting purposes (with no recognition of accounting netting), as provided in paragraph 35(i) of the Proposed Revisions, the counterparty credit risk has been captured (and, indeed, dramatically over-captured). Again, as in the case of the interplay between the notional amount add-on and the RC component for written credit derivatives, this double counts components of the exposure.

b. *High quality sovereign securities held through SFTs*

To avoid likely negative impacts on the market for sovereign securities, the Exposure Measure should exclude high quality sovereign securities to the extent they are held through SFTs. Such an exclusion is appropriate because of the high quality and liquid nature of sovereign securities and the important role SFTs play in the economy. In particular, governments primarily use the SFT markets to implement monetary policy and manage bank reserves, and this requires banks to be the counterparties to such transactions. Excluding high quality sovereigns, which frequently serve as collateral for SFTs,

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of the availability of daylight overdraft credit or other similar intraday credit facility to fund settlements. As a result, transactions settled through a CSS are effectively settled net even though they involve intraday transfers of gross amounts because only net amounts must be made available.

<sup>48</sup> Proposed Revisions ¶ 35(ii).

when they are held through SFTs is important to ensure that the supplementary leverage ratio does not interfere with these critical functions.

5. Results of The Clearing House Leverage Study.

The Clearing House Leverage Study results with respect to advanced approaches banks are scaled on a straight-line basis, based on total consolidated assets, to adjust for advanced approaches banks that were not Sample Banks.

Since the financial crisis, national regulators have substantially enhanced the robustness of regulatory capital measures (both as to the components of capital and the requirement minimum ratios), with the Basel III Framework being a centerpiece of those endeavors. Additionally, partly in response to those endeavors, banks have substantially increased the amounts of all three basic components of their capital – that is, CET1, additional Tier 1 capital, and Tier 2 capital. The Clearing House Leverage Study, which focuses on U.S. advanced approaches banks (including G-SIBs), shows that on average, reflecting the enhanced regulation of capital and capital-raising action since the financial crisis, U.S. advanced approaches banks and G-SIBs exceed the 3% supplementary leverage ratio threshold based both on the ratio as formulated in the Basel III Framework and after giving effect to the Proposed Revisions. However, when combined with the U.S. Leverage Proposal, U.S. advanced approaches banks and G-SIBs would have substantial Tier 1 capital short-falls under the supplementary leverage ratio. Specifically:

- U.S. advanced approaches banks would need \$202 billion in additional Tier 1 capital<sup>49</sup> or a reduction in exposure of \$3.7 trillion to be in compliance with the Proposed Revisions and U.S. Leverage Proposal if both are adopted (\$69 billion in additional capital or reduced exposures of \$1.2 trillion under the U.S. Leverage Proposal alone);
- If the Proposed Revisions and U.S. Leverage Proposal both are adopted and U.S. advanced approaches banks maintain a 100 to 200 basis point buffer above the minimum supplementary leverage ratio, they would need \$345 billion to \$501 billion in additional Tier 1 capital; and
- Total exposures increase from \$11.7 trillion under the U.S. banking agencies' existing leverage ratio, the denominator for which is based on average total consolidated assets determined in accordance with U.S. GAAP without adjustment for OBS, to \$16.4 trillion under the Basel III Framework, to \$19.1 trillion if the Proposed Revisions are adopted.<sup>50</sup>

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<sup>49</sup> See note 8 concerning the distance to compliance if the advanced approaches banks first raised the additional Tier 1 capital necessary to comply with the Basel III Framework's risk-based capital rules on a fully phased-in basis (including the capital conservation buffer and G-SIB surcharges where applicable).

<sup>50</sup> The Clearing House Leverage Study at 4.

The results of The Clearing House Leverage Study make it clear that:

- it is critically important to consider the Proposed Revisions not in isolation but along with other initiatives – most importantly, super-equivalent initiatives as proposed by the U.S. banking agencies for U.S. G-SIBs;
- by focusing on two asset classes and activities (derivatives and SFTs) in which the largest internationally active banks play the most important role, the potential for distortive consequences and impacts is particularly significant. That should not be a deterrent to arriving at accurate and realistic measures of exposure for those asset classes and activities, but it does place a substantial premium on making sure that the Exposure Measures for those assets and activities are in fact accurate and realistic and do not give rise to distortions in decision-making or consequences and impacts on the markets for affected assets and exposures (e.g., interest rates, foreign exchange and sovereign securities) that would be most affected by an over-statement without those consequences and impacts first having been analyzed and understood.

The results also provide useful guidance as to the relative effects on the Exposure Measure of the individual components of the measure. In particular:

- Capital shortfalls or the need to reduce exposures are most sensitive to changes in the following components of the calculation, each of which, as proposed, is an unrealistic measure of actual economic exposure:
  - the calibration of CCFs for undrawn commitments of U.S. advanced approaches banks (if the CCF for undrawn commitments were reduced to 50%, other things remaining constant, the additional Tier 1 capital required would be reduced by \$39 billion, from \$202 billion to \$163 billion);
  - the exclusion of cash from the Exposure Measure, which under the Proposed Revisions requires additional capital of \$49 billion;
  - the requirement to gross up the cash legs of reverse repo transactions rather than permitting netting with cash lent under repo transactions, which leads to a need for an additional \$33 billion of Tier 1 capital; and
  - the inclusion of exposures from centrally cleared derivatives, which require an additional \$26 billion in Tier 1 capital.
- Derivatives account for \$2.0 trillion of the increase in the Exposure Measure with the main factors leading to the increase being the inclusion of the notional value of written credit derivatives in the Exposure Measure, which comprises \$1.36 trillion of the impact and the gross-up for collateral received and collateral provided, which leads to \$0.55 trillion of the excess.<sup>51</sup>

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<sup>51</sup> The Clearing House Leverage Study at 4-5, 10

- For SFTs, the total increase in the Exposure Measure is \$0.72 trillion, which is largely the result of the gross up of the cash legs of reverse repo transactions (\$0.46 trillion).
- C. The Basel Committee should comprehensively revisit the calculation of the Exposure Measure and its components and, in particular, conform the supplementary leverage ratio's treatment of OBS exposures to the treatment in the Basel II standardized approach.<sup>52</sup>**

The Consultative Document focuses on derivative exposures and SFTs as components of the Exposure Measure. The Basel Committee's premise behind revisiting the supplementary leverage ratio's Exposure Measure seems focused on, and even biased toward, ensuring that the Exposure Measure errs sufficiently on the side of overstating exposures as opposed to whether its standards produce accurate and realistic measures of exposure, both in absolute and relative terms. The Clearing House strongly believes that the Basel Committee and national regulators, in establishing the Exposure Measure for different on- and-off balance sheet items, should have as their objective identification of accurate and realistic exposure amounts, with no bias in favor of either understating or overstating an accurate measurement. The Basel Committee has not articulated a standard for determining the supplementary leverage ratio's CCFs or, for that matter, the other components of the Exposure Measure. We believe that the supplementary leverage ratio's credibility would be enhanced if it did articulate a standard; and we strongly believe that the standard for each component (including on-balance sheet, OBS, derivative and SFT exposures) should be to arrive at as accurate and realistic a measure of the relevant exposure as possible, with no bias toward overstatement or understatement. Distorting contributions of particular assets or activities to the Exposure Measure inevitably will distort banks' fundamental business decisions, not only in ways that are at cross purposes with other regulatory initiatives (for example, the LCR and liquidity regulation more broadly, the G-SIB surcharge, requirements for margin, particularly requirements for increased margin for cleared derivative transactions, loss absorbency requirements to facilitate resolutions, and efforts to address vulnerabilities in short-term funding markets)<sup>53</sup> but also affecting what products banks make available to consumers or commercial entities and at what prices. Any consideration of the conservatism desired to be achieved through the supplementary leverage ratio to assure its proper functioning as a backstop to risk based measures should be addressed through its calibration, not through distortions of components in its denominator.

The supplementary leverage ratio leaves unchanged the original Basel III Framework's treatment of OBS items. The OBS items include "commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, stand-by letters of credit, trade letters of credit, failed transactions and unsettled securities."<sup>54</sup> The Consultative Document, like the Basel III Framework, does not follow the treatment of these items in the Basel II standardized approach, with its use of graduated credit conversion factors CCFs depending upon the nature of the OBS item, but instead applies a uniform 100% CCF. Additionally, it applies a 10% CCF to

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<sup>52</sup> Basel Committee, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework – Comprehensive Version* (June 2006) ("Basel II"). The Basel II standardized approach's CCFs are at ¶¶ 82-89.

<sup>53</sup> See notes 13-18.

<sup>54</sup> Basel III Framework ¶ 162.

unconditionally cancellable commitments, although as mentioned above the Basel Committee notes both in the Basel III Framework and in the Consultative Document that it will conduct further review of the 10% CCF for such commitments “to ensure that the 10% CCF is appropriately conservative based on historical experience.”<sup>55</sup> The Basel II standardized approach, by comparison, applies:

- a 0% CCF to unconditionally cancellable commitments;
- a 20% CCF to unfunded commitments with an original maturity up to one year;
- a 50% CCF to unfunded commitments with an original maturity of over one year;
- a 20% CCF to short-term self-liquidating trade letters of credit (including acceptances) arising from the movement of goods; and
- a 50% CCF to transaction-related contingent items (including, for example, stand-by letters of credit related to particular transactions).<sup>56</sup>

The Basel Committee has not asserted, either currently in the context of the Consultative Document or in connection with the Basel III Framework (either as proposed in December 2009 or finally adopted in December 2010), that its choice of a 100% CCF for OBS items and a 10% CCF for unconditionally cancellable commitments produces the most (or even an) accurate and realistic measure of exposure, and we are aware of no published support for the Basel Committee’s choice in the supplementary leverage ratio of a uniform 100% CCF for all committed OBS and a 10% CCF for unconditionally cancellable commitments. Nor has the Basel Committee explained the rationale behind its decision not to use the Basel II standardized approach’s CCFs in the supplementary leverage ratio. Consider commitments to lend – whether working capital facilities for businesses or liquidity facilities – as one example. There simply can be no question but that an assumed draw-down of 100% is no more accurate and realistic than an assumed draw-down of 0%; actual and realistic exposure is somewhere between the two extremes. The Clearing House Leverage Study shows that a worst-case realistic measure is approximately 10%, meaning that the supplementary leverage ratio’s 100% CCF exaggerates the exposure by a factor of 10.<sup>57</sup> To the extent businesses rely on committed lines as a credible funding source, if the leverage ratio becomes a binding constraint for a significant number of the G-SIBs that are among the largest lenders to commercial enterprises, the pool of available credit to support economic expansion will be constrained.

In the LE Consultative Document, the Basel Committee commented on the 100%/10% CCFs versus the Basel II standardized approach’s more graduated CCFs at some length. The Basel Committee proposed, in the LE Consultative Document, to apply a 100% CCF to OBS for large exposure limits, consistent with its “worst case” approach throughout the LE Consultative Document. The Basel Committee noted that it chose a 100% CCF for large exposure purposes “[s]ince the large exposures framework is focused on the maximum possible losses that could arise in the event of a sudden failure

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<sup>55</sup> Basel III Framework ¶¶ 163-164; Consultative Document ¶¶ 41-42.

<sup>56</sup> Basel II ¶¶ 83-85.

<sup>57</sup> The Clearing House Leverage Study at 11.

of a single counterparty, it is appropriate to assume that a counterparty will take all possible actions to prevent its failure.”<sup>58</sup> The Basel Committee went on to note:

“Another option would have been to apply the standardized CCFs (20%, 50% or 100% under the risk-based capital requirement). However, the underlying rationale of applying specific CCFs for risk-based capital requirement purposes is based on the portfolio approach applicable: i.e., given that capital is being set for a large number of exposures, it is reasonable to assume that within a given class of off-balance sheet exposures over a period such as a year, some will be drawn upon but not every one of that type. But this approach does not apply in a single-name large exposure context as the principal of the diversification is not relevant.”<sup>59</sup>

Plainly, the Basel Committee’s explanation of the Basel II standardized approach’s portfolio approach to CCFs is more apt for the leverage ratio than the “worst case” 100% assumption used in the LE Consultative Document, with the Basel II standardized approaches graduated CCFs based on “reasonable” portfolio assumptions. The Clearing House, in its comment letter on the supplementary leverage ratio as initially proposed in December 2009,<sup>60</sup> urged the Basel Committee to adopt the Basel II standardized approach’s treatment of OBS for purposes of the supplementary leverage ratio. We continue to believe that is the proper course; a leverage test is designed to be realistic for all banks, and not realistic for some and “worst case” for others.

First, the Basel II CCFs are merely tools for estimating exposure amounts to which risk-weightings under the standardized approach would be applied. They are not risk-weightings, and the estimation of those amounts is not intended to be a direct “cure” for the perceived weaknesses in risk-based capital measures (whether uncertainty as to the adequacy of risk-weightings or the reliability of internal models). As a measure of actual exposure (based on a portfolio approach applying reasonable assumptions, as noted by the Basel Committee) and not a risk-weighted measure of exposure, we see no basis for concluding that the Basel II CCFs are inappropriate for purposes of the supplementary leverage ratio and that the “worst case” CCFs used for large exposure purposes are appropriate.

Second, the Basel III Liquidity Framework’s LCR requires a similar calculation – that is, for purposes of determining total net cash outflows over the next thirty calendar days, what proportion of OBS items should conservatively be expected to be drawn and therefore become on-balance sheet items. The LCR assumes a stress scenario that “entails a combined idiosyncratic and market-wide shock”.<sup>61</sup> Notwithstanding its stress assumptions, the LCR provides for draw-down rates (equivalent to CCFs) for committed facilities of 5% (in the case of retail and small business customer borrowers); 10% for committed credit facilities to non-financial corporates (among others); 30% for committed liquidity facilities to non-financial corporates (among others); 40% for committed credit and liquidity facilities extended to banks subject to prudential supervision; 40% for committed credit facilities to other

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<sup>58</sup> *Id.* ¶ 63.

<sup>59</sup> *Id.* ¶ 64.

<sup>60</sup> Letter, dated April 16, 2010, from The Clearing House to the Basel Committee commenting on the 2009 Basel III Consultative Document, pages 26-27.

<sup>61</sup> Revised Basel III Liquidity Framework ¶ 19.



financial institutions including securities firms, insurance companies, fiduciaries and beneficiaries; and 100% for certain other committed credit and liquidity facilities (including to SPEs).<sup>62</sup> And it gives national regulators discretion to establish draw-down rates for, among others, “unconditionally revocable ‘uncommitted’” credit and liquidity facilities.<sup>63</sup> Although the considerations in the context of liquidity risk differ from those in the context of capital adequacy, we would expect the liquidity standard, with its stress assumptions, to be more severe.

Third, actual bank experience with draws under OBS items of the relevant types – most importantly, unfunded credit facilities, unconditionally cancellable commitments and trade finance transactions (particularly letters of credit and acceptances) – shows draw-down or usage rates that not only do not approach the punitive assumptions in the supplementary leverage ratio but are dramatically less than reflected in the Basel II standardized approach’s CCFs or in the LCR’s assumed draw-down rates.

Fourth, as noted above, CCFs that are biased toward “worst case” conservatism, as opposed to simply achieving an accurate measure of exposure, are inherently distortive. It is extremely important that the Basel Committee, national regulators more generally and banks analyze and understand the impact of unnecessarily conservative and punitive CCFs for OBS as a component of the Exposure Measure. This becomes particularly crucial if the supplementary leverage ratio becomes the binding constraint and not merely a backstop for the banks most active in many of these areas. Credit and liquidity facilities, unconditionally cancellable facilities and trade finance transactions tend to be low-margin businesses – because of their low risk – and this is reflected in pricing. Trade finance in particular is largely the purview of the larger internationally active banks, with its low risk content deriving from its very nature as short-term financing supporting the movement of goods and the provision of services. The Basel Committee acknowledged the special role of trade finance in the LE Consultative Document, commenting that it considers it “inappropriate to apply the flat 100% CCF to specific types of exposure if there is a risk that this could have material unintended consequences,” as in the case of “trade finance activities, where the application of a flat 100% CCF is likely to have a material adverse impact on an essential form of financing in some countries, in particular, in emerging markets.”<sup>64</sup> Similarly, unconditionally cancellable liquidity facilities supporting short-term corporate funding needs, including as commercial paper backstops, are largely written by the same banks. The impact of the Proposed Revisions on global trade is particularly troublesome and requires consideration by the Basel Committee in its own QIS as well as by industry participants and national regulators.

If these banks need to reduce their Exposure Amounts in order to comply with the supplementary leverage ratio, inevitably these low-risk low-margin activities will be affected. It is essential that the Basel Committee evaluate the impact on global trade and the impact on corporate financing of inventories and other operations and economic activity with the best available data. We anticipate that The Clearing House Leverage Study and the Global Study will contribute to an understanding of these considerations but strongly believe that the Basel Committee must undertake a more comprehensive review, perhaps as part of the QIS discussed in Part II.A.

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<sup>62</sup> Revised Basel III Liquidity Framework ¶¶ 126 to 131.

<sup>63</sup> Revised Basel III Liquidity Framework ¶ 140.

<sup>64</sup> LE Consultative Document ¶ 66.

In short, the supplementary leverage ratio's use of a 100% CCF for OBS items and a 10% CCF for unconditionally cancellable commitments is not supported by experience, even in extreme circumstances. By not being premised on the objective of establishing the most accurate and realistic exposure amounts that can be established under the circumstances, with a bias neither toward understatement nor overstatement, but instead with a "worst case" bias replicating the Basel Committee's proposed treatment of large exposures, the supplementary leverage ratio's CCFs are inherently distortive. Although the CCFs used in the Basel II standardized approach are themselves conservative, they have the benefit of having been used and accepted for a substantial period of time in a Basel Committee framework that, insofar as Exposure Measures are concerned, should have the same objective – an accurate and realistic measure. At the least, we urge the Basel Committee to conform the CCFs in the supplementary leverage ratio to the CCFs used in the Basel II framework.

**D. The supplementary leverage ratio must accommodate increases in banks' assets, both temporary and sustained, that occur as a result of macro-economic factors and monetary policy decisions, particularly during periods of financial market stress, by excluding central bank placements from the Exposure Measure.**

Experience during and since the financial crisis has shown that some banks face substantial increases in customer deposits during periods of market uncertainty, resulting in increases in total assets that can be quite significant. This includes custody banks which maintain the operational accounts of buy-side clients that may respond to market uncertainty by scaling back or repositioning their investment portfolios. Custody banks may also experience spikes in client deposit activities due to their role as intermediaries in the global payment, clearing and settlement systems. The increased initial and variation margin that investors will be required to maintain when participating in derivatives transactions are likely to further increase assets held in custody arrangements, and may therefore exacerbate normal course volatility in client deposits at custody banks.<sup>65</sup> Apart from the particular circumstances of custody banks, many other banks have experienced spikes in deposits in recent years as a consequence of a general "flight to quality" during periods when customers lose confidence in the markets.

Perhaps more significantly, the implementation of monetary policy, may have a similar but more broad-based impact, and its duration may be more prolonged because it depends on decisions taken by central banks (e.g. through bond-buying programs).

The banking system is the natural residing place for excess customer deposits during periods of uncertainty, and regulators should not want to disrupt that natural flow, either by forcing banks to effectively turn away deposits (for example, by charging additional fees on accounts) or diverting funds to the shadow banking system. We therefore strongly believe that the Basel Committee should address this concern by excluding from the Exposure Measure placements held at national central banks. Such an exclusion would have absolutely no impact on banks' potential for leverage: it neither permits banks to apply those excess funds to make loans nor increases banks' equity in a manner that permits increased lending. In the absence of such an exemption, it is important to consider the likely mitigation strategies that banks will feel compelled to employ in order to accommodate balance sheet volatility, particularly if the proposed changes to the supplementary leverage ratio are combined with higher

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<sup>65</sup> See the discussion in Part II.B.2.

minimum ratios as envisioned by the US banking regulators (the U.S. Leverage Proposal's calibrations at 5% for bank holding companies and 6% for depository institutions). This might include the scaling back of payment, clearing and settlement activities, and aggressive measures to dampen client deposit inflows. Indeed, the effect of such strategies may be felt even outside of periods of market stress, with the potential consequence that cash may flow from regulated institutions to the shadow banking sector.

**E. The Basel Committee should exclude from the Exposure Measure a limited group of assets and exposures the inclusion of which frustrates other regulatory initiatives – namely, (i) derivatives exposures arising from transactions cleared through CCPs and (ii) assets that are pledged by a bank, as required by local laws, to secure deposits of PSEs.**

1. Derivatives Exposures Arising from Transactions Cleared through CCPs.

The Consultative Document does not expressly address the anticipated treatment of derivatives exposures arising out of transactions cleared through CCPs. We strongly believe that exposures arising out of transactions cleared through CCPs should be excluded from the Exposure Measure, at least initially, to support the policy objective of moving standardized OTC derivative transactions to central clearing. The Basel Committee and the international community more generally, acting through the G20, have identified as a policy objective reducing risk in the financial system by encouraging the clearance of standardized derivatives and other financial products through CCPs.<sup>66</sup> Furthermore, there are likely to be relatively few CCPs, at least initially, and including in the Exposure Measure a distorted component with respect to CCP exposures would be inconsistent with national and international efforts to increase centralized clearing and “preserving incentives for central clearing.”<sup>67</sup> Moreover, the Basel committee should complete its own on-going consideration of measurement methodologies for capital requirements relating to exposures arising out of transactions cleared through CCPs<sup>68</sup> before making a decision with respect to the treatment of those transactions' exposures for purposes of the supplementary leverage ratio.

A bank's counterparty risk in the case of an OTC derivative or an SFT not cleared through a CCP is vastly different from counterparty risk to a CCP. CCPs are or will be subject to increased regulatory scrutiny and heightened supervision, including margining requirements. Nonetheless, if exposures arising out of transactions cleared through CCPs are not excluded altogether, we strongly believe that banks' exposures to CCPs relating to the bank/CCP leg of derivative transactions where the bank is acting as a clearing member for its client (and the bank does not guarantee the client's performance) should be excluded from the Exposure Measure. Such an exclusion would be consistent with the treatment under the Basel III Framework's capital treatment of this leg of a cleared transaction. The reason for the exclusion in part is to support, and be consistent with, the policy objective of moving standardized OTC derivative transactions to central clearing. But the more fundamental and substantive reason is that, were the bank/CCP leg of the transaction subject to an Exposure Measure calculation like

<sup>66</sup> See Section 804 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, for example, with respect to U.S. initiatives.

<sup>67</sup> Basel CCP Consultative Document ¶ 3.

<sup>68</sup> Basel Committee, *Consultative Document: Capital Treatment of Bank Exposures to Central Counterparties* (June 2013, rev. July 2013) (“**Basel CCP Consultative Document**”).

any other derivative transaction, the result would be an Exposure Measure for the clearing bank related to this client-driven activity that is substantially over-stated as compared to any accurate and realistic measure.

If the clearing bank/client leg of the transaction is included in the Exposure Measure, we believe the following adjustments are appropriate given rules protecting client money and requiring segregation of funds that prohibit the clearing bank from using client collateral as an economic resource:

- recognize the full benefit of cash collateral offsets and netting through an adjusted CEM or a revised and appropriately calibrated NIMM, which, as adjusted to reflect industry comments, is the better approach due to the shortcomings of CEM noted by the Basel Committee and discussed above;
- exclude any on balance sheet cash received as variation margin or initial margin by a clearing bank from its clients from the Exposure Measure; and
- provide for a shorter margin period of risk in recognition of the fact that there will be a more rapid closeout than with a conventional bilateral OTC counterparty because the agreement with the client generally does not include a grace period.

The same adjustments are appropriate for transactions cleared through CCPs and initiated by a bank acting for its own account (referred to as “house” or “proprietary” trades).

Any final revisions to the supplementary leverage ratio should, in any event, exclude default fund contributions from the Exposure Measure to ensure that the supplementary leverage ratio does not “create disincentives to the maintenance of generous default funds.”

## 2. Assets Securing PSE Deposits.

Most U.S. PSEs, such as states, counties, municipalities, public utilities and similar entities, must under applicable law maintain deposits that have been collateralized with U.S. government obligations. These PSEs often receive earnings credit on the deposits and use it to pay for banking services. A bank holding PSE deposits must purchase the U.S. obligations to collateralize the deposits. The collateral banks must acquire will result in an additional capital cost because the additional collateral is included in the Exposure Measure. This in turn could have an adverse impact on PSEs, including through higher costs or other steps banks may take to address the added capital cost. Accordingly, we request that assets securing deposits of PSEs be excluded from the Exposure Measure.

**III. Other Comments.****A. For components of the Exposure Measure where daily information is available, banks should be permitted to use daily information instead of month-end information for averaging purposes.**

The Consultative Document retains the Basel III Framework's requirement that the Exposure Measure be calculated using the average of the three month-end spot leverage ratios over a quarter.<sup>69</sup> While monthly averages produce more accurate and relevant results than quarter-end measures, they are inferior to the use of daily averages, where available. In many jurisdictions, including the United States, a number of the components of the Exposure Measure are available on a daily basis. Indeed, the existing U.S. leverage ratio is calculated using daily averages. Preventing the use of daily averages will lead to skewed results that overstate the impacts of common month-end balance sheet management activity. Most financial markets participants process payments, de-risk operations, or otherwise produce notable cash outflows at the end of each month or quarter. Although month-end information is appropriate for many banks, for some banks, measurements that do not account for such common balance sheet maintenance will have unduly punitive consequences for firms receiving cash inflows. These flows disproportionately end up on the balance sheets of financial institutions with large asset servicing operations, such as custody banks. Indeed, it is not uncommon for custody banks to have month-end and quarter-end on-balance sheet assets that are significantly greater than daily averages. Absent the option to calculate components of the Exposure Measure on a daily basis, many banking organizations, particularly custody banks, will be forced to use peak total asset figures that provide an inaccurate picture of their normalized on-balance sheet assets.

**B. The Basel Committee should retain Tier 1 capital as the numerator for the supplementary leverage ratio.**

As noted in Part II.A, the Basel Committee has indicated that it will continue to examine whether the right component for the numerator of the supplementary leverage ratio is Tier 1 capital or whether, instead it should be CET1 or total capital. We strongly believe that Tier 1 capital is the appropriate measure. The elements of Tier 1 capital – including but not limited to CET1 – are intended to absorb unexpected losses on a going concern basis. Indeed, the Basel III Framework further strengthens the definition of Tier 1 capital to ensure its loss absorbing character for going concerns. Tier 1 capital no longer includes hybrid instruments that proved not to be adequately loss absorbing during the financial crisis; instead, the “predominant form of Tier 1 capital must be common shares and retained earnings.”<sup>70</sup> In addition, most Tier 1 capital must be “instruments that are subordinated, have full discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.”<sup>71</sup> These Tier 1 capital instruments are clearly the type that would absorb unexpected losses on a going concern basis, such as perpetual non-cumulative preferred stock.

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<sup>69</sup> Consultative Document ¶ 6.

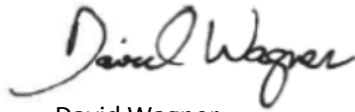
<sup>70</sup> Basel III Framework ¶ 9.

<sup>71</sup> *Id.* ¶ 9.

\* \* \*

If you have any questions or need further information, please contact me at 212.613.9883 (email: david.wagner@theclearinghouse.org).

Respectfully submitted,



David Wagner  
Executive Managing Director  
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cc: Hon. Daniel K. Tarullo  
*Board of Governors of the Federal Reserve System*

Hon. Thomas J. Curry  
*Office of the Comptroller of the Currency*

Hon. Martin J. Gruenberg  
*Federal Deposit Insurance Corporation*

The Honorable Mary Miller  
*Department of the Treasury*

Mr. Cyrus Amir-Mokri  
*Department of the Treasury*

Mr. Matthew Rutherford  
*Department of the Treasury*

Mr. George French  
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## ANNEX 1

# Assessing the Supplementary Leverage Ratio



September 20, 2013

# Executive summary

**We have supplementary leverage exposure and capital data as of 2Q 2013 covering 100% of US G-SIB assets, and ~93% of total US domiciled Advanced Approach (AA) BHC assets<sup>1</sup>, which together comprise approximately 65% of overall US banking and securities industry assets<sup>2</sup>**

- Total exposures in our data increase from \$11.7T under US Leverage Ratio, to \$16.4T under the US exposure measure, and to \$19.1T using the Basel proposed exposure measure

**Analysis indicates that the Enhanced Supplementary Leverage Ratio (SLR) could require up to \$202B<sup>3</sup> of additional Tier 1 capital or require exposure reductions of \$3.7T, if the US 5-6% G-SIB minimum is combined with the Basel proposed exposure measure**

- To meet a 3% ratio under either exposure definition requires <\$10B in incremental capital
- To meet a 5-6% ratio under the US exposure measure, banks need to reduce exposure by ~\$1.2T or raise ~\$69B in capital
- If the US were to adopt the changes to the exposure measure in the Basel proposed SLR in combination with the 5-6% ratio, banks would need to reduce exposure by ~\$3.7T or raise ~\$202B in capital, which represents 19.6% of covered industry exposure and 24.3% of covered industry Tier 1 Capital, respectively
- Historically, firms have operated in excess of supervisory minimums, and if banks were to hold voluntary buffers of 50-200 bps above the 5-6% minimum SLR, the capital shortfall would range from \$273-\$501B

**At a 5-6% minimum with Basel proposed exposure measure, leverage would become the binding constraint for 67% of US G-SIBs or ~40% of the overall US banking and securities industry<sup>2</sup> (measured as a percentage of total assets)**

**The SLR and corresponding capital shortfall would be most sensitive to the following changes in the exposure measure: (1) Reduced CCFs for undrawn commitments, (2) the exclusion of cash<sup>4</sup>, (3) the allowance of netting for SFTs<sup>5</sup>, and (4) the exclusion of centrally cleared derivatives from the exposure measure<sup>6</sup>**

**We have also analyzed impacts on a number of individual products. Leverage may make it uneconomic, all else equal, for banks to hold or provide <364 day unfunded revolvers, cash, US Treasuries, reverse repos, vanilla interest rate swaps, and CDS on corporate bonds**

1 As estimated by all US domiciled Advanced Approach BHCs

2 Calculated as the sum of Private Depository Institution (\$15.24T) assets plus Broker-Dealer assets (\$2.05T), as of 1Q 2013

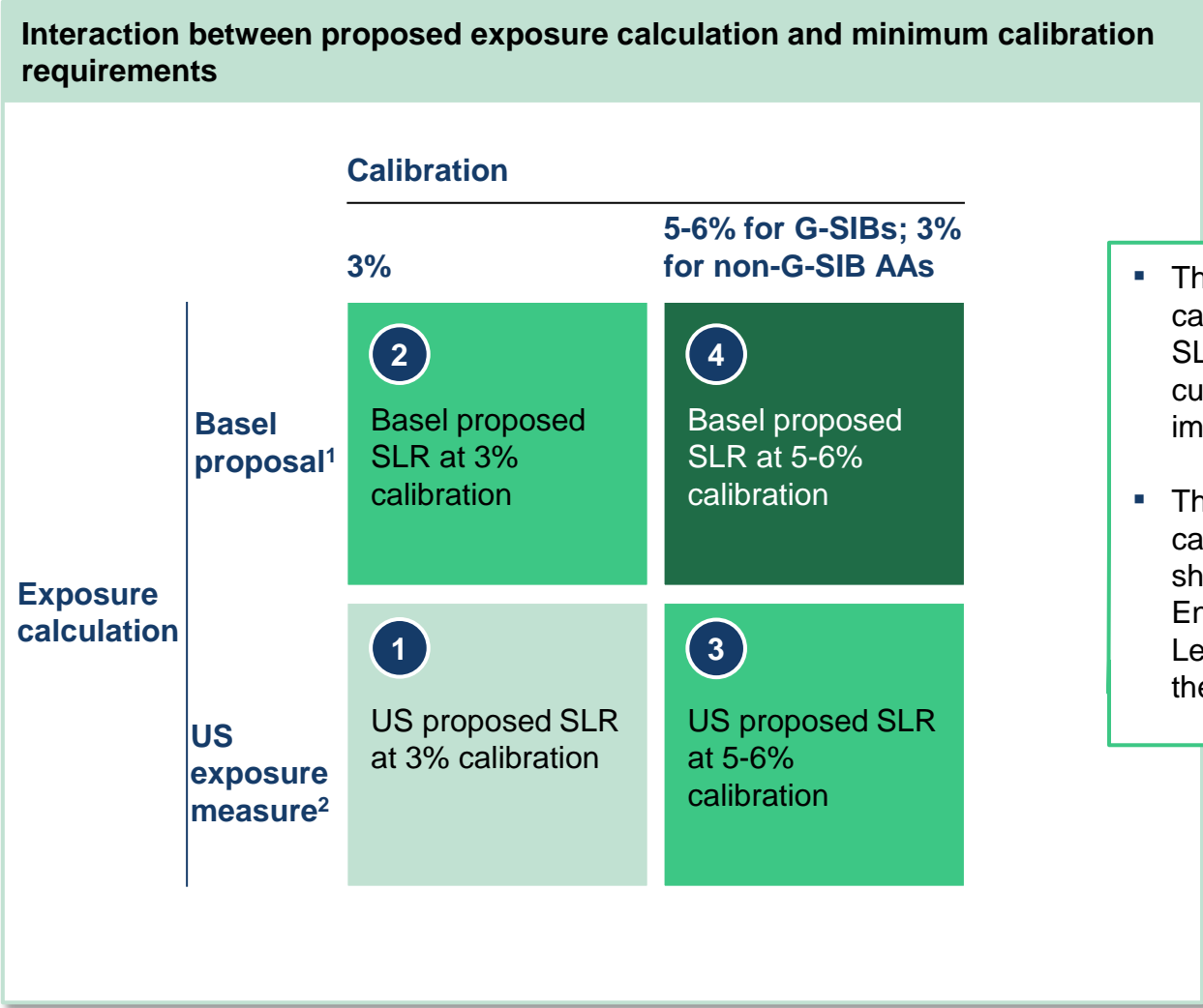
3 If U.S. advanced approaches banks first raised additional Tier 1 capital necessary to comply with the Basel III Framework's risk-based capital rules on a fully phased-in basis (including the capital conservation buffer and G-SIB surcharges where applicable), banks still need to raise an additional \$185 billion of Tier 1 capital to be in compliance with the 5-6% minimum combined with the Basel exposure measure

4 Cash held at the central bank and vault cash

5 Including margin lending

6 Treatment of centrally cleared derivatives for leverage ratio purposes is still evolving; this study assumes no difference in leverage ratio treatment between centrally cleared and OTC

# Given the proposed changes to the SLR exposure calculation and the minimum calibration requirements, there are 4 scenarios to examine



- The Basel proposed SLR at 3% calibration and the US proposed SLR at 5-6% calibration are both currently under consideration for implementation
- The Basel proposed SLR at 5-6% calibration is a possible outcome should the US update its current Enhanced Supplementary Leverage Ratio proposal to include the Basel exposure calculation

1 As described in the Consultative Document “Revised Basel III Leverage Ratio Framework and Disclosure Requirements”, available at <http://www.bis.org/publ/bcbs251.htm>

2 As defined in the US Basel III Final Rule Section 2, definition of “Total Leverage Exposure”, page 552, available at <http://www.federalreserve.gov/bcreg20130702a.pdf>

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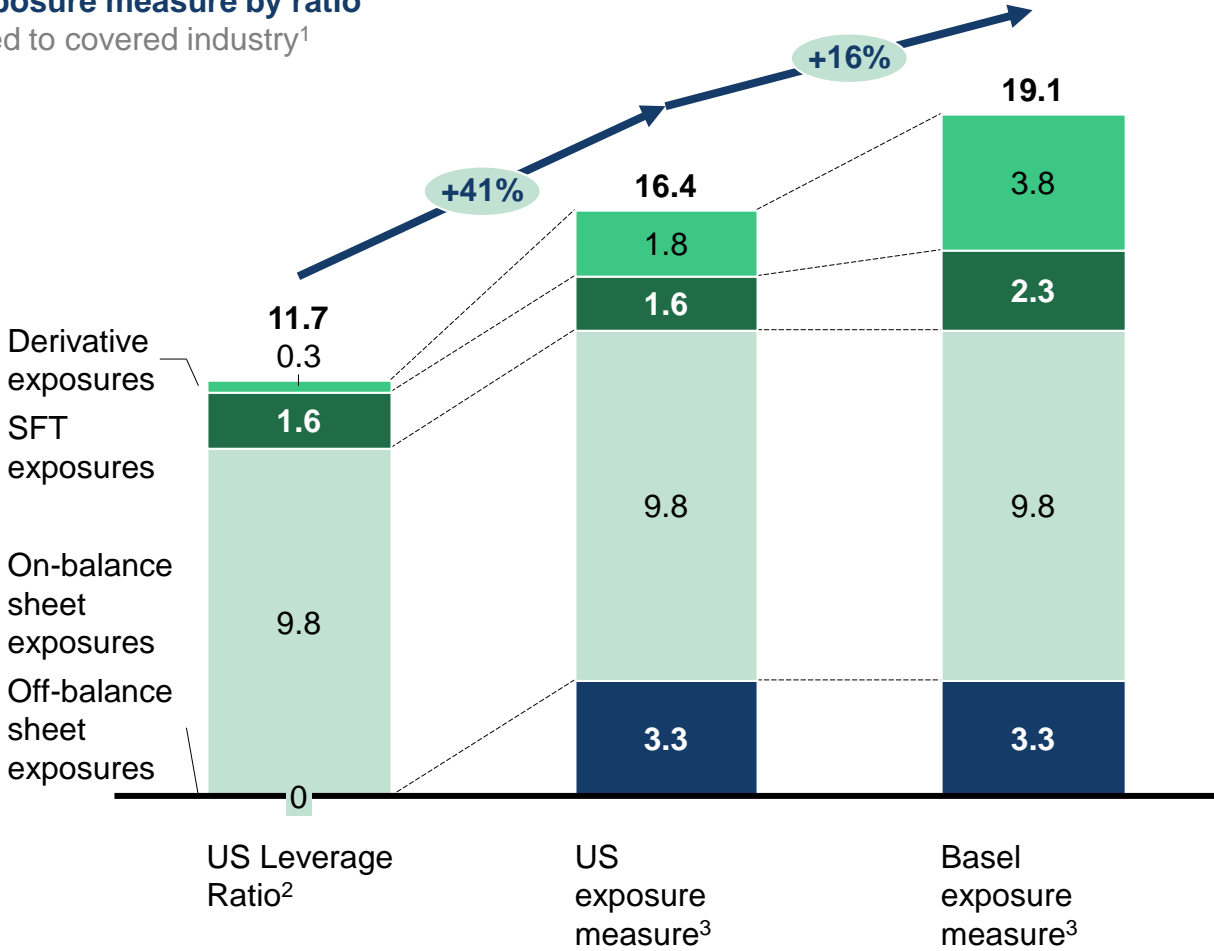
- **Distance to compliance**
  - Sensitivity analysis
  - Product economics

# Increase in the exposure measure in the Basel proposed SLR is driven by SFT and derivative treatment

Overall exposure measure increases by 16% from US proposed to Basel proposed exposure measure

## BHC exposure measure by ratio

\$T, scaled to covered industry<sup>1</sup>



1 As estimated by all US domiciled Advanced Approach BHCs

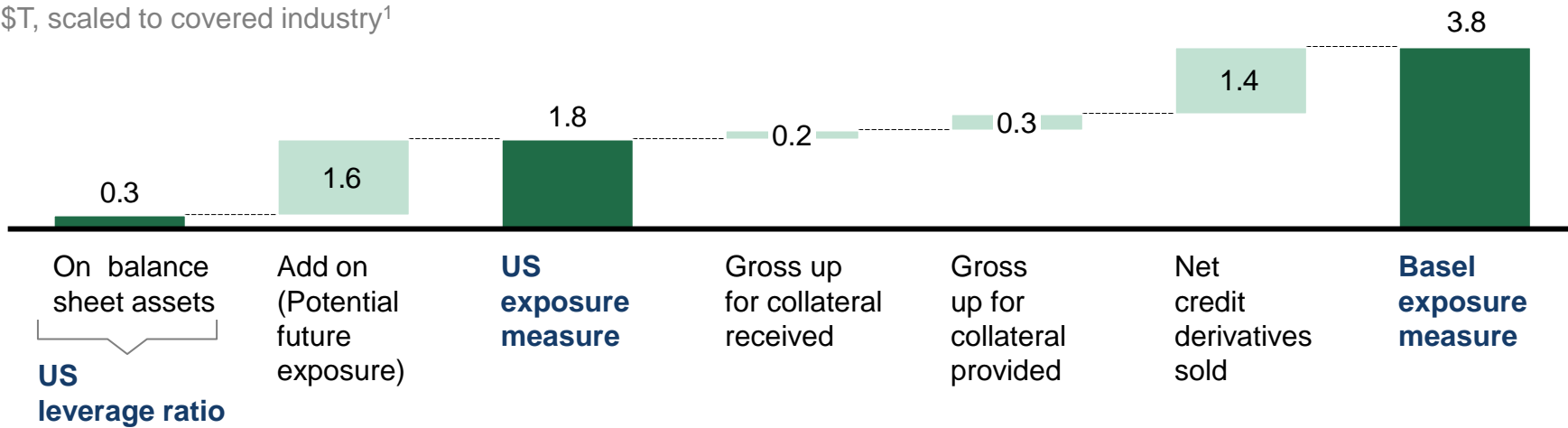
2 On-balance sheet assets

3 See notes 1 and 2 on page 2 of this document for definition of the relevant exposure measures

# Buildup of derivative and SFT treatment across exposure measures

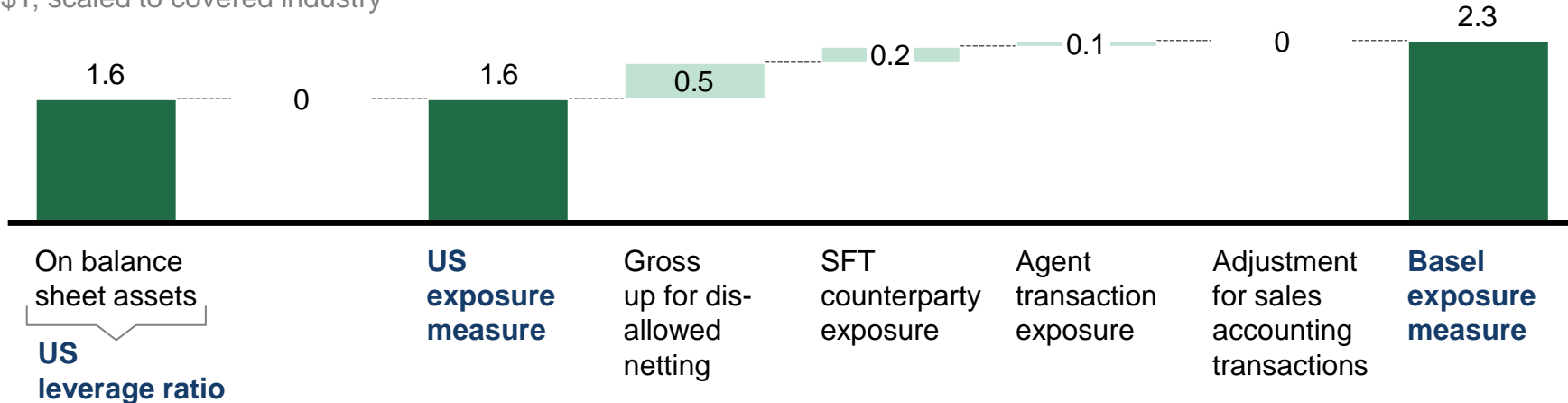
## Derivative treatment across exposure measures

\$T, scaled to covered industry<sup>1</sup>



## SFT treatment across exposure measures

\$T, scaled to covered industry<sup>1</sup>



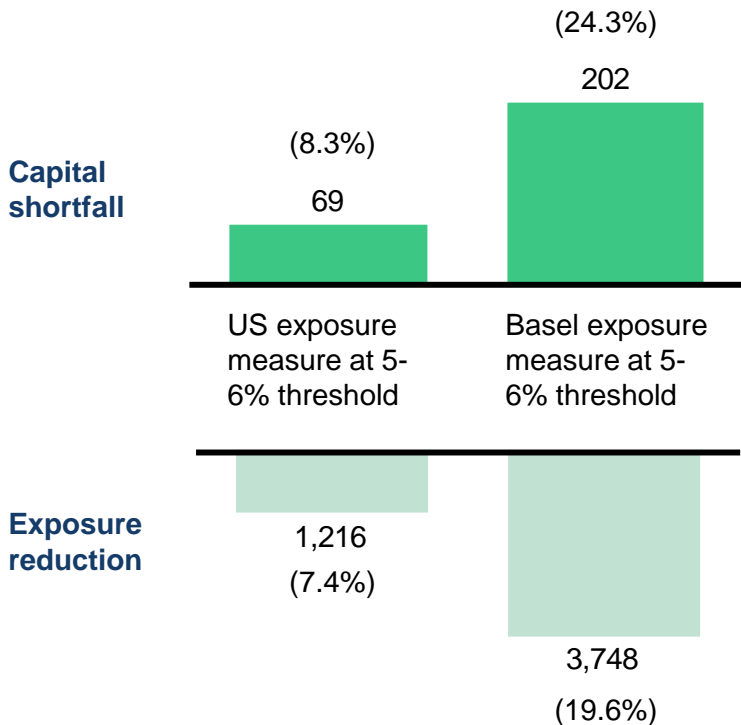
<sup>1</sup> As estimated by all US domiciled Advanced Approach BHCs  
 Note: Numbers may not add due to rounding to nearest \$0.1T

# US BHCs may need to raise \$202B<sup>1</sup> Tier 1 capital or reduce \$3.7T of exposures if the US adopts the Basel proposed exposure measure in combination with a 5-6% minimum SLR for G-SIBs

Should the US adopt the Basel proposed exposure measure in combination with the 5-6% calibration, banks would need to increase capital by 24%...

### Total gap to compliance for reporting banks

(Percent of current, scaled to covered industry<sup>2</sup>)  
 \$B, scaled to covered industry<sup>2</sup>

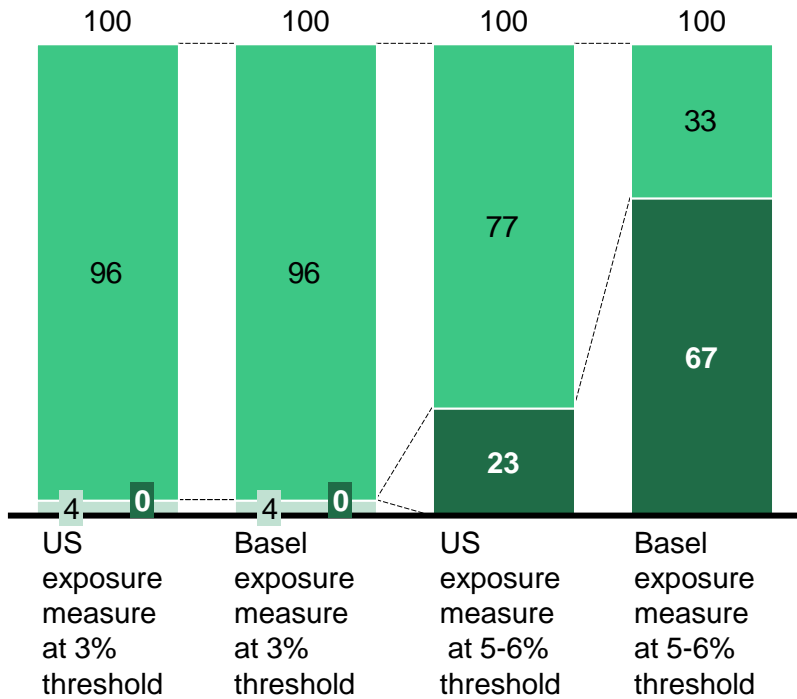


... and the SLR would become the binding constraint<sup>3</sup> for 67% of US G-SIB assets or ~40% of US banking and security assets<sup>4</sup>

### Binding constraint for G-SIBs

Percent of bank assets

- Tier 1/ RWA<sup>5</sup>
- SLR
- US Leverage Ratio

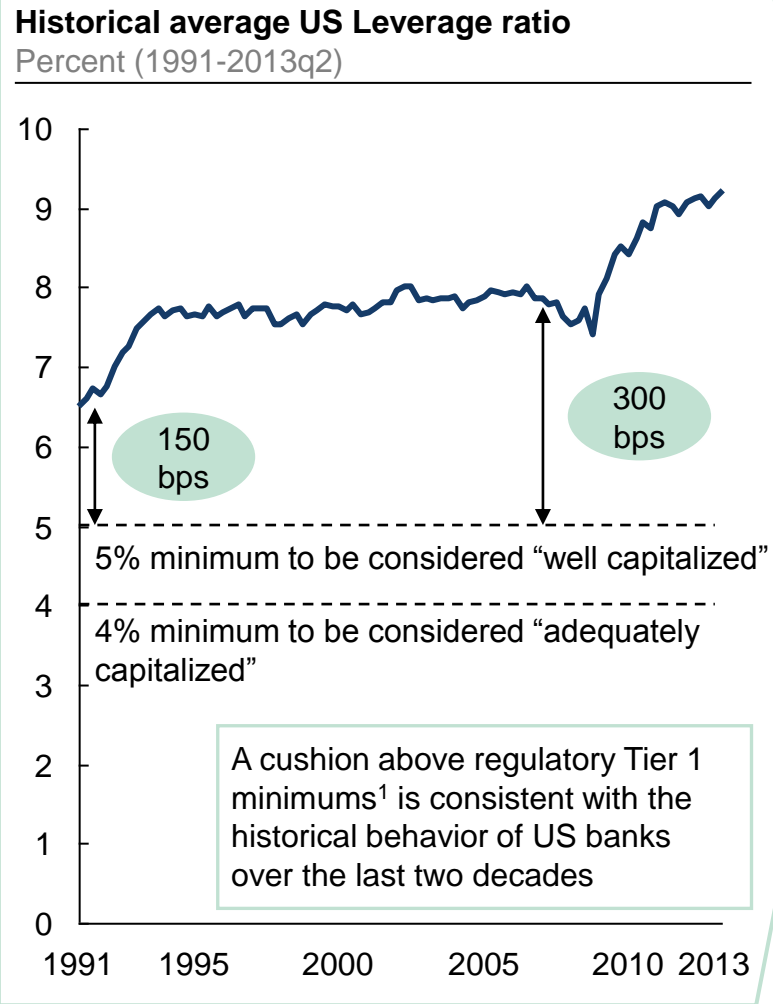


1 If U.S. advanced approaches banks first raised additional Tier 1 capital necessary to comply with the Basel III Framework's risk-based capital rules on a fully phased-in basis (including the capital conservation buffer and G-SIB surcharges where applicable), banks still need to raise an additional \$185 billion of Tier 1 capital to be in compliance with the 5-6% minimum combined with the Basel exposure measure  
 2 As estimated by all US domiciled Advanced Approach BHCs  
 3 The SLR is binding on a bank if that bank has an SLR shortfall after meeting minimum Tier 1 to RWA ratios including capital conservation buffer and G-SIB surcharges  
 4 Calculated as the sum of Private Depository Institution (\$15.24T) assets plus Broker-Dealer assets (\$2.05T), as of 1Q 2013  
 5 Basel III RWA that is the binding constraint for each institution

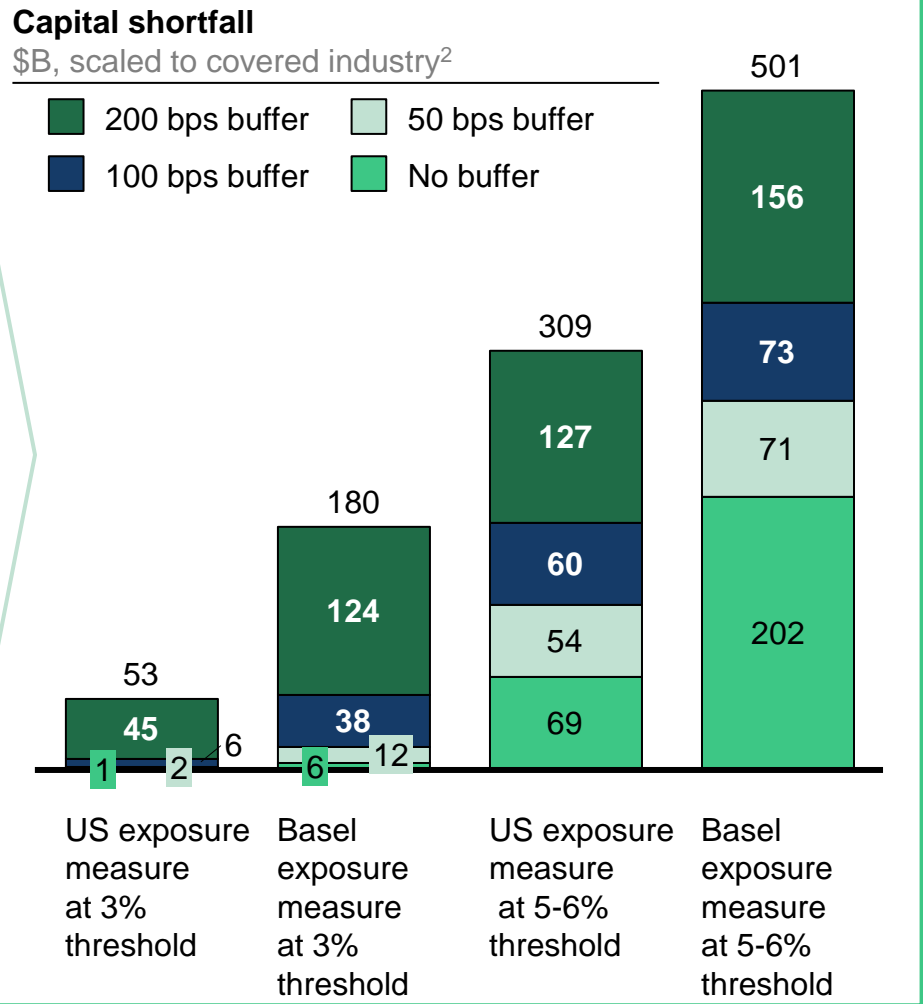


# Holding an additional capital buffer of 50-200 bps could increase the Tier 1 capital shortfall to \$273-\$501B

Banks have historically held buffers above the minimum required US leverage ratio...



...and could hold a capital buffer above the Supplementary Leverage Ratio

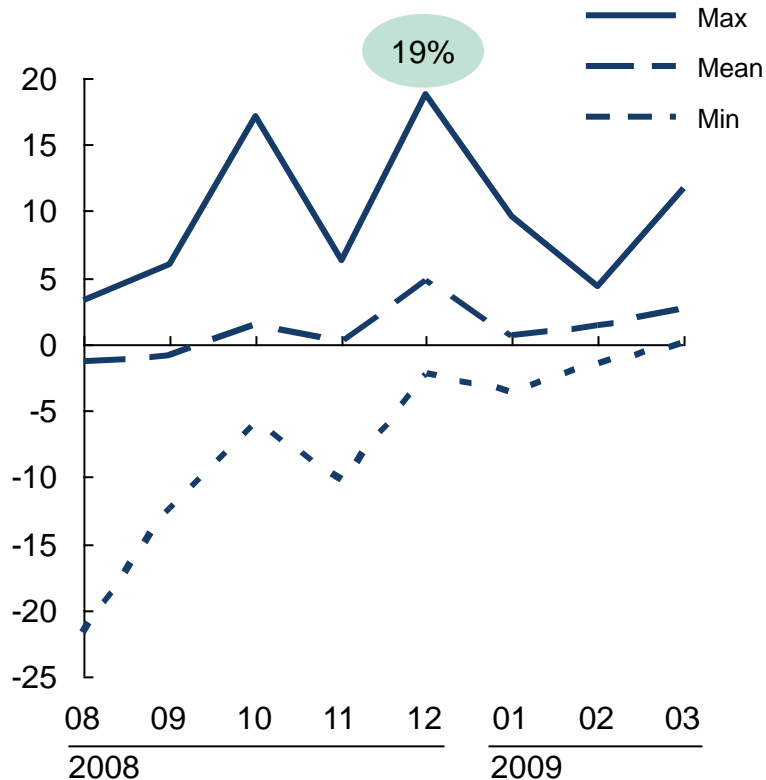


<sup>1</sup> Analysis on risk-based capital ratios Tier 1 to RWA over the same time period indicates that banks on average also maintained buffers from 200-350 bps above Tier 1 risk-based minimum requirements for "well capitalized"  
<sup>2</sup> As estimated by all US domiciled Advanced Approach BHCs

# Fluctuations in deposit levels will help to inform the size of the Tier 1 capital buffer banks choose to hold

Flight to quality during the recession, increased individual bank monthly deposits by as much as 19%

Monthly change in deposit growth and run-off  
Percent



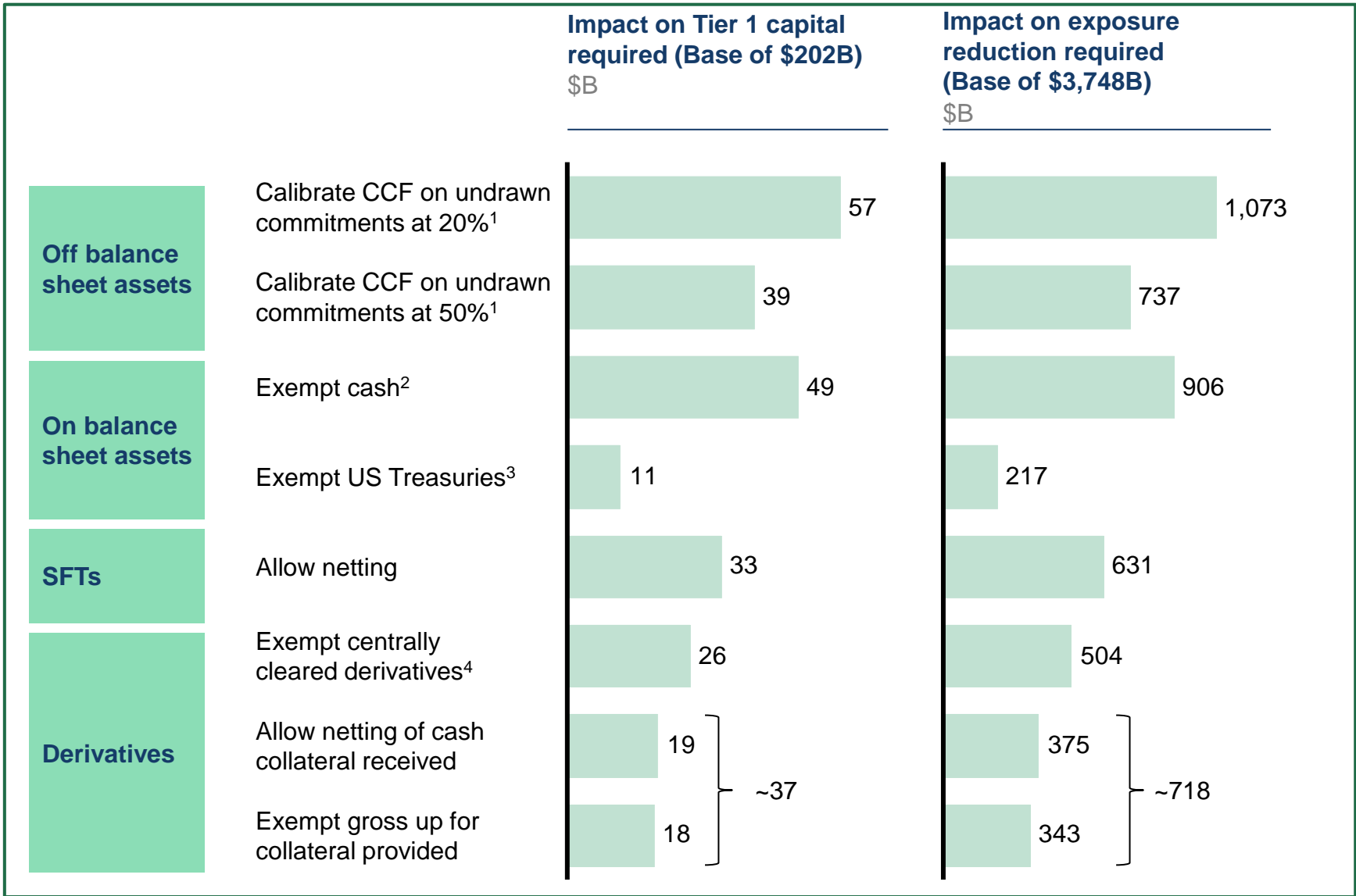
- A 19% increase in deposits would require 95 bps of additional Tier 1 Capital for banks to meet the SLR at the 5% calibration
- Banks will likely consider past fluctuations in both deposit and asset levels when determining appropriate SLR capital buffer
- Changes to Tier 1 capital definition, like the removal of the AOCI filter, further increase the potential need for and size of the voluntary buffer

Source: US Banking Industry Liquidity Update, TCH report December 2012 (<http://www.theclearinghouse.org/index.html?f=074638>) and Assessing the Liquidity Coverage Ratio, TCH report November 2011, (<http://theclearinghouse.org/index.html?f=074617>)

# Contents

- Distance to compliance
- **Sensitivity analysis**
- Product economics

# Sensitivity analysis – impact of potential changes to exposure measure



1 Under the Basel proposed SLR, undrawn commitments are treated with a CCFs of 100%

2 Cash held at central bank and vault cash

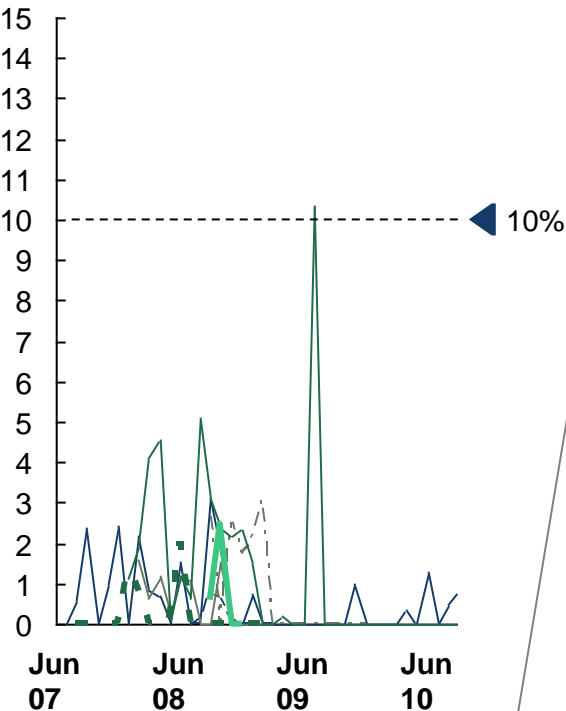
3 As included in High Quality Liquid Assets (defined under the LCR)

4 Treatment of centrally cleared derivatives for leverage ratio purposes is still evolving; this study assumes no difference in leverage ratio treatment between centrally cleared and OTC

# CCFs are 10x higher under the SLR than the maximum quarterly draw as seen in TCH-collected crisis experience

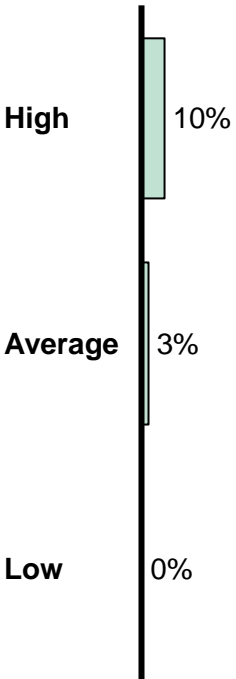
In the crisis, the maximum monthly draw down of credit lines was ~10%

**Historical drawdown of credit lines at non-financial corporates<sup>1</sup>**  
Percent



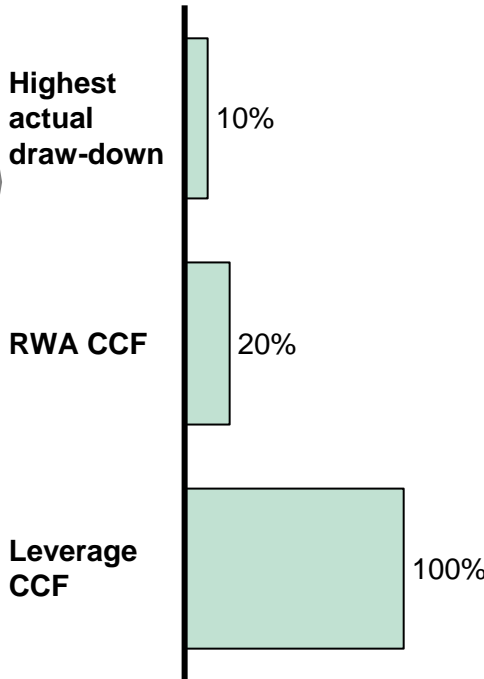
Over cumulative 3-month periods, the maximum draw down was also 10%...

**Cumulative 3-month drawdown of credit lines at non-financial corporates**  
Percent



...which is 90% lower than the 100% potential draw-down implied under the leverage ratio

**Implied potential draw-down of undrawn credit lines**  
Percent



<sup>1</sup> Based on 57% of industry undrawn line credit in an industry with \$816B in capacity  
Source: TCH, *Assessing the Liquidity Coverage Ratio*, November 2011 available at <http://theclearinghouse.org/index.html?f=074617>

# Contents

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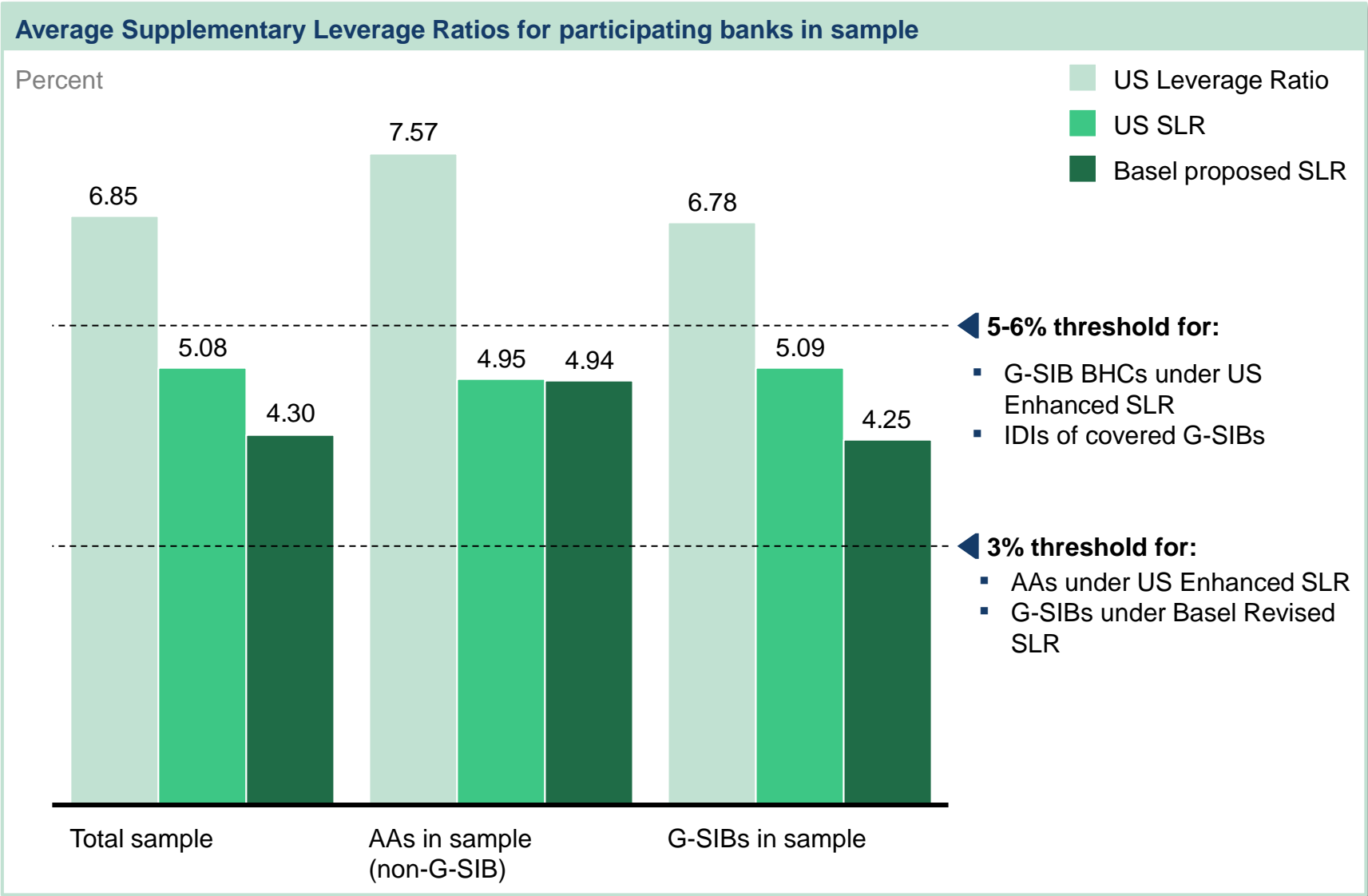
# Based on inputs from member banks, we analyzed a set of products that might be impacted by the SLR

Category	Product
On balance sheet items	<ul style="list-style-type: none"><li>▪ Cash</li><li>▪ Treasuries</li><li>▪ Corporate bonds</li><li>▪ Corporate loans</li><li>▪ Mortgages</li></ul>
Off balance sheet items	<ul style="list-style-type: none"><li>▪ Credit cards</li><li>▪ Short-term unfunded revolvers</li><li>▪ Short-term, self-liquidating trade finance</li></ul>
SFTs	<ul style="list-style-type: none"><li>▪ Reverse repos on treasuries</li><li>▪ Reverse repos on Agency MBS</li><li>▪ Reverse repos on corporate bonds</li></ul>
Derivatives	<ul style="list-style-type: none"><li>▪ Cleared vanilla interest rate swaps</li><li>▪ OTC interest rate swaps</li><li>▪ CDS on Corporate bonds</li></ul>

# Appendix



# For our sample, the Basel proposed SLR has a more significant effect on G-SIBs than on non-G-SIB Advanced Approach (AA) banks



1 As estimated by all US domiciled Advanced Approach BHCs

# Intercompany lending potentially inflates minimum capital required to meet the SLR

**A BHC with a \$200B inter-company loan will be required to hold more capital than a BHC without inter-company loans**

	<u>BHC</u>	<u>IDI 1</u>	<u>IDI 2</u>	<u>Non-IDI</u>
Regulatory SLR minimum	5.00%	6.00%	6.00%	n/a

## Bank A

Current Tier 1 capital level	70	30	30	10
<b>Current exposure level</b>	<b>1,600</b>	<b>700</b>	<b>900</b>	<b>200</b>
Current SLR	4.38%	4.29%	3.33%	n/a
Gap to compliance	0.63%	1.71%	2.67%	n/a
Implied add. capital needed	10	12	24	n/a
<b>Total add. capital needed</b>	<b>36</b>			

## Bank A (without inter-company loans)

Current Tier 1 capital level	70	30	30	10
<b>Current exposure level</b>	<b>1,600</b>	<b>500</b>	<b>900</b>	<b>200</b>
Current SLR	4.38%	6.00%	3.33%	n/a
Gap to compliance	0.63%	0.00%	2.67%	n/a
Implied add. capital needed	10	0	24	n/a
<b>Total add. capital needed</b>	<b>24</b>			

Due to an inter-company loan between IDI 1 and IDI 2, there is \$200B in exposure on IDI 1's balance sheet. At the BHC level, this loan is netted out. However, since IDI's are subject to a 6.00% SLR, IDI 1 must raise \$12B to become compliant

If the inter-company loan is removed, Bank A's IDI 1 exposure is reduced by \$200B, but the BHC exposure remains unchanged

The elimination of the inter-company loans reduces capital needed by \$12B

## ANNEX 2

### Example 1

For example, if a written credit derivative has a notional of \$100 and the value of the underlying bond falls to \$80, assuming both are fair valued, the bank would record a loss of \$20 (i.e., reduce capital, the numerator, by \$20), and typically the bank would be required to post out \$20 of cash collateral to the counterparty. The Exposure Measure as proposed would require a total of \$120 to be included, comprising the \$100 notional plus the \$20 of cash collateral posted, i.e. \$40 more than the maximum remaining loss that the bank could suffer on the trade (since capital could only be diminished by a further \$80). The Basel Committee notes that the purpose of requiring the full notional for written credit derivatives is to treat them “consistently with cash instruments (e.g. loans, bonds) for the purposes of the Exposure Measure.” In this example, however, if the bank held the bond directly it would have to include \$80 in the Exposure Measure (i.e., the market value of the bond) compared to the \$120 on the written credit derivative, and there is no basis for this inconsistency, i.e., there is no additional leverage in the credit derivative compared to the bond. The further the bond falls in value, the bigger the difference between how the proposal would treat the bond and a written credit derivative referencing that bond becomes, e.g., if the bond falls to \$30, only \$30 is included in the Exposure Measure, but the derivative would be included at \$170 (\$100 notional plus \$70 cash collateral posted). Even if written credit derivatives are treated differently, the exposure should be capped at the maximum economic loss – the value of the underlying bond.

Example 2

Assume a bank executes the following four trades:

	Notional	Tenor
Bought	\$ 200	4
Bought	\$ 100	5
Sold	\$ 100	4
Sold	\$ 200	5

Assume the bank takes these positions and offsets them at each maturity, which results in the following net positions:

	Net Notional	Tenor	Explanation
Bought	\$ (100)	4	The \$100 net "bought" position arises when the \$200 bought protection with a tenor of 4 years is netted with the \$100 sold protection with a tenor of 4 years
Sold	\$ 100	5	The \$100 net "sold" position arises when \$200 sold protection with a tenor of 5 years is netted with \$100 bought protection with a tenor of 5 years.

The bank's true exposure is calculated as:

$$\frac{[(\text{Notional of Bought Protection} \times \text{Tenor}) + (\text{Notional of Sold Protection} \times \text{Tenor})]}{(\text{Sold Protection} \times \text{Tenor})}$$

which equals:

$$\frac{[(-\$100 \times 4) + (100 \times 5)]}{(100 \times 5)} = 20\%$$

Thus, the gross written exposure that should be included in the exposure measure is 20 percent of the net written notional of \$100, or \$20.

### Example 3

An example illustrates the significant overstatement of a bank's actual exposure to an SFT transaction under the Proposed Revisions. First, in a standard SFT, the lender requires the borrower to over-collateralize the transaction. Thus, assume a bank enters into a reverse repo with a counterparty in which the bank lends \$100 in cash and receives \$104 in securities. Assume the bank also enters into a repo with the same term and same counterparty in which the bank borrows \$50 in cash and provides \$52 in securities. Further assume that these transactions are subject to a legally enforceable netting agreement and will settle net or settle through a securities settlement system that results in the functional equivalent of net settlement. Under the Proposed Revisions, the bank would be required to include the \$100 gross "SFT assets" for the reverse repo and would not receive any exposure-reducing benefit for the partially offsetting repo transaction. In contrast, the bank would only be subject to a \$50 net economic exposure due to its set-off rights and settlement mechanism. Thus, the \$100 gross exposure amount doubles the actual economic exposure in this example.

As described above, under the Proposed Revisions, the bank's Exposure Measure would include \$100 of the bank's gross "SFT assets" (the reverse repo exposure) that would not be netted with the \$50 repo exposure. In addition, under the formula used in the Proposed Revisions to calculate the replacement cost for transactions covered by a master netting agreement ("MNA"), there would be no add-on: the total value of cash and securities lent to the counterparty, \$152, less the total value of cash and securities received from that counterparty under the MNA, \$154, is less than zero; therefore no add-on applies.

If instead the bank enters into the same reverse repo transaction lending \$100 in cash and receiving \$104 in securities, but in the repo transaction increases the securities collateral it provides to \$60 in order to borrow the \$50, the result is different: the total value of the cash and securities lent to the counterparty would increase to \$160, while the total value of the cash and securities received would remain \$154; as a result, the bank would have a \$6 add-on (\$160 less \$154). The Exposure Measure for the bank would thus be increased by \$106: \$100 for the gross SFT assets because there is no recognition of netting, plus \$6 for the add-on.

This \$106 exposure amount is greater than the maximum loss the bank could suffer (\$50 of net economic exposure resulting from \$100 reverse repo and \$50 repo, which is also mitigated by the net collateral underlying both transactions).

As discussed above, a net by counterparty measurement is far more appropriate than "gross SFT assets." Should the final supplementary leverage ratio retain the "gross approach," however, we believe that the SFT counterparty risk add-on should be eliminated: the net counterparty exposure measures the excess of the bank's exposure over the bank's collateral and is intended to capture the risk of the bank losing securities or cash provided to the counterparty. In the example above, the bank either (1) carries the \$60 securities on its balance sheet, which would have been captured in the Exposure Measure, the incremental \$6 (essentially a portion of the \$60 already on balance sheet) would constitute double counting, or (2) borrows the securities through a securities lending or reverse repo transaction in which the gross amount would have been captured and adding the \$6 on top of that would again be a double count. Thus, the counterparty exposure add-on should be removed.