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# Leverage ratio and client clearing

ACPR discussion paper

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## Summary

During the Basel Committee's consultation on the revised leverage ratio standard, launched in April 2016, the industry highlighted possible adverse effects on the ability of clearing members to continue offering clearing services to third parties through a central counterparty clearing house (CCP). The main point underlined was that, as a non-risk based measure, the leverage ratio, ignores the risk-reducing effect of initial margins received by banks from their clients in derivatives transactions conducted through clearing houses. Consequently, several responses to the consultation called for, *inter alia*, deduction of initial margins from the denominator of the leverage ratio.

In the finalised Basel III agreement, which was published in December 2017,<sup>1</sup> the Committee left the leverage ratio's treatment of derivatives transactions unchanged, but included a review clause stating that it would further analyse the impact of the ratio on client clearing and conclude on any possible changes to the rule before January 2019. The possible disincentives generated by the ratio could conflict with the central clearing obligation for standardised derivatives set by the G20 Pittsburgh summit in September 2009 and implemented in Europe by EMIR<sup>2</sup> and in the United States by the Dodd-Frank Act.<sup>3</sup>

While the lack of recognition of the risk-reducing effect of initial margins ("IM offset") for leverage ratio purposes is consistent with the objective of supplementing the solvency ratio with a non-risk based measure, the penalisation of client clearing activities may entail risks to financial stability that need to be assessed. Indeed, the withdrawal of some client clearers from the market would result in a higher concentration of activities among a limited number of clearing members, which would make it harder for clearing members to take on the positions of another member in the event of the latter's default (portability). Moreover, there is renewed pressure to provide non-bank actors with some form of direct access to CCPs, raising questions about compliance with prudential regulations and about the potential impact on the risk profile of CCPs. In any case, an extension of CCP membership – limited to certain regulated entities – would only be possible if it were accompanied by an adequate framework for managing and controlling risks.

The purpose of this discussion paper is to initiate debate on the potential impact on client clearing of the leverage ratio's non-recognition of initial margins received by clearing members from their clients in derivatives transactions. It opens the way for a possible revision of the leverage ratio, to allow for IM offset in the calculation of exposures.

<sup>1</sup> <https://www.bis.org/bcbs/publ/d424.pdf>

<sup>2</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32012R0648&from=FR>

<sup>3</sup> [https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/file/hr4173\\_enrolledbill.pdf](https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/file/hr4173_enrolledbill.pdf)

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## Introduction

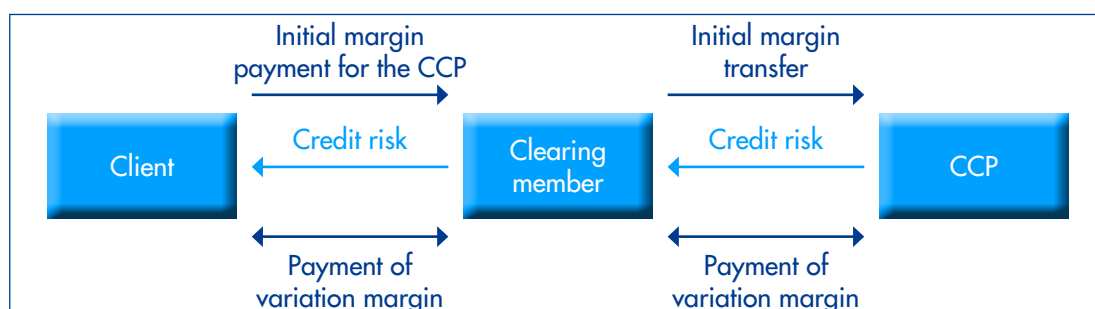
# What is a clearing member?

In the aftermath of the 2008 crisis, G20 members decided to strengthen central clearing incentives in order to reduce counterparty risk among financial system participants, and agreed to make central clearing mandatory for standardised, liquid OTC derivative contracts. In central clearing, a central counterparty (CCP) interposes itself between the participants in a transaction and becomes their single counterparty (novation principle). The CCP thus concentrates all the counterparty risk.

Participants dealing directly with CCPs are called **clearing members**. Joining the CCP involves a number of financial requirements, aimed at reducing the risk of the CCP: contribution to a guarantee fund, payment

of daily (initial and variation) margins, obligation to take on the positions of a defaulting player (portability). Since these constraints require a certain level of liquidity and of financial robustness, clearing members are typically large financial institutions, in particular banks.

There are two categories of membership: i) individual clearing members acting on their own behalf and ii) general clearing members acting on behalf of their clients. Clearing members may thus provide clients wishing to trade derivatives with a **client clearing service**. Under this system, the clearing member acts as an intermediary between its client and the CCP, and all or part of the associated financial flows (margins, settlements) transit through it.



# Regulatory framework: treatment of derivatives in the leverage ratio and central clearing obligations

## 1 Leverage ratio

Introduced by the Basel Committee as part of the Basel III framework (December 2010), the leverage ratio is intended as a simple measure to supplement the solvency ratio - which divides banks' Tier 1 capital by their risk-weighted exposures - and has two main objectives: (i) to control excessive increases in the size of bank balance sheets, and (ii) to reduce the model risk related to the calculation of the solvency ratio (the "backstop function").

The calculation of the leverage ratio, which divides Tier 1 capital by total on- and off-balance sheet exposures, is largely based on accounting data, to which certain prudential adjustments are applied to eliminate or mitigate differences in accounting rules (mainly between IFRS and US GAAP). In principle, this ratio is insensitive to risk (unlike the solvency ratio) and therefore does not take into account any credit risk mitigation techniques.

Initially introduced<sup>4</sup> as a Pillar 2 measure,<sup>5</sup> the leverage ratio became a Pillar 1 standard at the international level<sup>6</sup> in 2018<sup>7</sup> with a 3% minimum requirement, to which

a surcharge for systemic banks will be added. Since 2015 it has been published by banks.

$$\text{Leverage ratio: } \frac{\text{Tier 1 Capital}}{\text{Balance sheet and off-balance sheet exposures}} \geq 3\%$$

## 2 The prudential treatment of derivatives in the leverage ratio

Currently, in the leverage ratio, derivatives exposures are calculated according to the current exposure method (CEM), which is also used for the calculation of the solvency ratio. The exposure amount is equal to the replacement cost (RC) of the exposure, plus a counterparty credit risk add-on (potential future exposure - PFE) which is a percentage of the notional amount.

Under the changes made as part of the finalisation of Basel III, the current exposure method has been replaced by the new standardised approach to counterparty credit risk (SA-CCR), which features a similar RC + PFE structure and will apply to the solvency ratio as from the entry into force in the European Union of the revised Capital Requirements Regulation (CRR 2).

<sup>4</sup> It has been in force in Europe since the implementation of the Capital Requirements Regulation (CRR) in 2014.

<sup>5</sup> Where calibration is specific to each bank.

<sup>6</sup> Where calibration is the same for all banks.

<sup>7</sup> In Europe the transition to Pillar 1 will be effective as soon as the revised Capital Requirements Regulation (CRR 2) enters into force.



However, in the Basel standard, the CEM and SA-CCR have been adapted to the principles of the leverage ratio so that collateral cannot be offset against exposures. Initial margins, in so far as they can be re-used by clearing members, are a potential source of leverage. Although there is little information available about the relationships between clearing members and their clients - these relationships are governed by a contract whose terms are known only by the parties - the re-use of collateral is theoretically possible in Europe, on the basis of the Financial Guarantees Directive.<sup>8</sup> The latter makes this possibility conditional on the client's agreement, and the collateral receiver has an obligation to pay back an equivalent amount of collateral to the client. In this respect, at the European level, segregation as provided for in Article 39 of the EMIR Regulation does not preclude the re-use of collateral.

The leverage ratio provides an exception for *variation* margins in cash, which may be deducted from the replacement cost under certain conditions. Indeed, the payment of the variation margin in cash may be viewed as a "pre-settlement payment" which reduces the market value exposure of the position to zero. Hence, derivative exposures can be reduced up to this amount.

Moreover, where collateral received in the form of initial margin is recognised as an asset on the balance sheet - which is typically the case of cash IM, but may also be the case for securities IM under some accounting standards - such collateral shall be included in the denominator of the leverage ratio. Where the collateral is re-used and remains recognised as assets on the institution's balance sheet, it shall also be included in the denominator of the leverage ratio.

In addition, a specific treatment<sup>9</sup> exists allowing clearing members to exclude their derivative exposures to the CCP from the denominator of the leverage ratio. This exemption can only be granted if the clearing member is not contractually obliged to reimburse the client for any losses suffered in the event that a CCP defaults. This derogation has been included in similar terms in European regulation and extended to repurchase transactions ("repos"), securities lending and similar transactions ("Securities Financing Transactions").<sup>10</sup> Hence the question of whether the leverage ratio should be reviewed only applies to clearing members' client exposures and to cases where clearing members provide the CCP with a performance guarantee for their clients' positions.

In response to the demands of the industry, the Basel Committee decided to further explore the potential impact of the leverage ratio on the activity of clearing members. The replacement of the CEM by the SA-CCR has gone some way towards reducing the constraints on members. This is due, among other things, to the application of the SA-CCR's margin period of risk (MPOR)<sup>11</sup> used for the solvency ratio,<sup>12</sup> which allows a more favourable treatment of centrally cleared derivatives (as a result of, *inter alia*, the daily exchange of variation margin) by reducing the potential future exposure amount (PFE). This recognition of MPORs for the leverage ratio was confirmed by the Basel Committee.

In this context, the question arises as to whether it would be appropriate to provide additional relief, by increasing convergence towards the SA-CCR method used in the calculation of the solvency ratio - in other words allowing an IM offset in the calculation

8 Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards lined systems and credit claims.

9 Paragraph 41 of the Basel standard for the leverage ratio.

10 Article 429(11) of Commission Delegated Regulation (EU) 2015/62 of 10 October 2014 amending Regulation (EU) No 575/2013 of the European Parliament and of the Council as regards the leverage ratio

11 The margin period of risk (MPOR) refers to the period between the last exchange of collateral on margins before a default and the re-placement of the transaction on the market after the default, during which the market value of the transaction may change. A reduced 5-day MPOR applies to centrally cleared derivatives transactions with daily variation margin exchanges between clearing members and their clients.

12 An MPOR of at least 10 days shall apply for transactions subject to daily variation margin on non-centrally cleared trades, compared with 5 days for transactions subject to daily exchanges of variation margin between clearing members and their clients.

of the potential future exposure (PFE) component of derivative exposures.<sup>13</sup>

### 3 The review clause on the treatment of initial margin

Respondents to the consultation launched by the Basel Committee in spring 2016 suggested that the absence of an IM offset would result in higher costs for clients of clearing members, lower profitability, increased sector concentration and fewer incentives for central clearing, the latter being presented as contrary to the G20 mandate of fostering central clearing.

In the Basel III finalisation agreement published on 7 December 2017, the Committee decided not to recognise any IM offset in the calculation of the leverage ratio of clearing members, while agreeing to conduct a review of the impact of the leverage ratio on the activity of clearing members by January 2019. This review will be conducted in coordination with the Derivative Assessment Team of the Financial Stability Board (FSB), which is responsible for reviewing the effectiveness of the incentives to centrally clear OTC derivatives by the end of 2018.

**At the European level, in contrast to the Basel Committee's current treatment, the review of the Capital Requirement Regulation (CRR 2)<sup>14</sup> proposed by the European Commission in November 2016 provides for an IM offset in the calculation of clearing members' exposures for the leverage ratio.<sup>15</sup> In addition to the impact on PFE (see new Article 429 c (5)), the proposal also goes further by allowing collateral to be taken into account in the NICA calculation item which determines the replacement cost (see Article 429 c (4)).<sup>16</sup>**

13 This article covers only initial margins, as opposed to variation margins, the exposure-reducing effect of which is recognised when they are paid in cash.

14 [Proposal of 23 November 2016 for a regulation of the European Parliament and of the Council amending Regulation \(EU\) No 575/2013 as regards the leverage ratio, the net stable funding ratio, own funds and eligible liabilities requirements, counterparty credit risk, market risk, central counterparty exposures, exposures to collective investment undertakings, large exposures and reporting and publication requirements amending Regulation \(EU\) No 648/2012](#)

15 Note that the measures approved by the Financial Services Commission of the US House of Representatives on 21 March 2018 include a bill allowing initial margins collected for centrally cleared derivatives to be deducted from the denominator of the supplementary leverage ratio.

16 In SA-CCR, NICA is the "net independent collateral amount", which corresponds to the net initial margins (initial margins received - initial margins posted). NICA is a calculation element that reduces replacement cost (RC). Thus, in the unmodified SA-CCR, the higher the initial margin received, the more the RC decreases. For a margined derivative, the RC is equal to [market value - variation margin received - NICA].

17 In the European Union, these are European indices iTraxx Europe Hand 5 Y and iTraxx Europe Crossover 5 Y.

## 4 Regulatory central clearing obligations

The central clearing obligation, introduced in the European Union by the EMIR Regulation, and in the United States by the Dodd-Frank Act, relates to two types of instruments: on the one hand, interest rate derivatives in the form of sufficiently standardised interest rate swaps, forward rate agreements (FRA) and overnight index swaps (OIS); and, on the other hand, credit derivatives in the form of credit default swap indices.<sup>17</sup>

For interest rate derivatives, the clearing obligation entered into force in the United States as of February 2013. In the European Union, it was implemented gradually, coming into force in June 2016 for clearing members, at the end of 2016 for other financial counterparties and in 2017 for non-financial counterparties falling within the scope of the central clearing obligation.

For credit derivatives, the clearing obligation entered into force in February 2013 in the United States. In Europe, it entered into force in February 2017 for clearing members and in August 2017 for other counterparties active in this segment.



#### QUESTION 1

Do you agree with the assessment of the benefits that would be associated with taking into account an IM offset?

#### QUESTION 2

In your view, what would be the impact of a failure to recognise this effect?

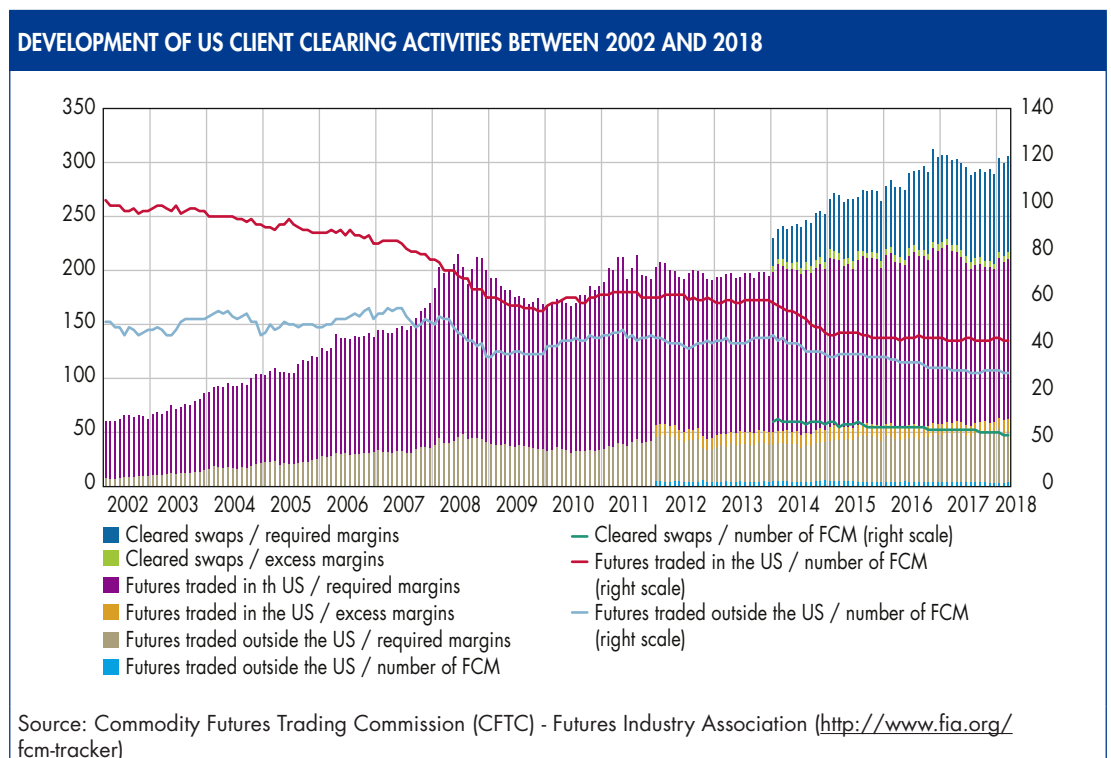
# Recent developments in the client clearing market

## 1 Developments on the supply side

The chart below, based on data from the Commodity Futures Trading Commission (CFTC), illustrates the trends in margins since 2002 for three types of client account held with clearing members (Futures Commission Merchants - FCMs) in the United States: (i) accounts for futures traded on US platforms; (ii) accounts for futures traded on non-US platforms; and (iii) accounts for cleared swaps. The chart

looks at two elements: margins received from clients (left-hand axis) and the number of active FCMs in different market segments (right-hand axis).

The main reason for the decline in the number of FCMs between 2002 and the 2008 crisis was the ongoing consolidation of the sector at the time in the United States. Following the crisis, the continued decrease can still be explained by the consolidation trend, but can also be attributed to regulatory changes in





the United States and to post-crisis regulation. It is likely that the clearing obligations introduced by the Dodd-Frank Act initially incentivised banks to invest in the client clearing business in anticipation of higher volumes. This was probably followed by a gradual phase-out after 2014, possibly in connection with the implementation of Basel III.

The decline in the number of clearing members in the United States was mentioned in particular by the Chairman of the CFTC, J. Christopher Giancarlo, in a speech in June 2017,<sup>18</sup> in which he highlighted the withdrawal of several banks, including State Street, Bank of New York-Mellon, Nomura, RBS and Deutsche Bank. The work carried out by the Banque de France and the ACPR, including interviews with market participants, confirms that the demand for clearing is increasing as a result of regulation, but also that more attention is being paid by clearing members to the impact of client clearing on their own funds.

Several clearing members say they are prepared to accept new clients, depending on regulatory developments, which could indicate that banks still have some capacity. However, the same players find that the cost of client clearing is increasing, in particular as a result of regulation, resulting in increases in the prices applied by clearing members. In parallel, in line with the remarks made by the CFTC Chairman, a number of partial or total withdrawals from the client clearing business have been reported. Such withdrawals could partly explain the reported increase in demand, as some institutions have noted a tendency for clients to use more than one clearing member simultaneously, to ensure they still have access to clearing services in

the event one member withdraws from the market.

In any case, banks are keeping a close eye on the profitability of their client activities. As a result, clearing is usually offered as part of a package of services (for example, with custodial services), but does not appear to be used as a loss leader.

Supply pressures also seem to be felt by end-users. Some suggest that clearing members are reducing the scope of collateral they accept either in terms of quality or by imposing additional haircuts. They also say that some clearing members have ceased their client clearing activities altogether or frozen their customer base.

Clients have also observed changes in pricing policy on the part of clearing members, resulting in higher prices and/or changes in the way they charge for services. In some cases, fees have apparently shifted from a percentage of the initial margin in basis points to a more complex system taking into account the ability to net client positions.

In order to limit exposures, clearing members use several techniques. Some ask their clients to compress their trades in order to optimise the number of exposures between two counterparties, a technique which is not always compatible with directional portfolios, as these offer limited opportunities to offset buy and sell positions. They also try to remove initial margins from their balance sheets by fulfilling the conditions for “derecognition” under the accounting standards.<sup>19</sup> Finally, CCPs are broadening access to their services and allowing clients to participate directly, generally with the backing of a regular clearing member (see 2.2 below on so-called “sponsored access”).

<sup>18</sup> <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22>

<sup>19</sup> IFRS and US GAAP have no specific treatment for initial margins. Generally, they use similar (but not fully identical) tests to determine whether an asset can be derecognised. These tests focus on four general criteria: (a) segregation from other assets; (b) non-reusability by the receiver; (c) no variable profit related to asset management; (d) no investment risk on the asset. In recent years, several clearing members have adjusted their contracts to ensure that the initial margin received meets these criteria (e. g. prohibition of re-using the margin, transfer of the margin to a third party or structuring of profits to meet the definition of “fee” rather than variable yields). However, when derecognition is subject to an accounting judgment, it is impossible to confirm that the same economic fundamentals have consistently led to the same accounting effects.

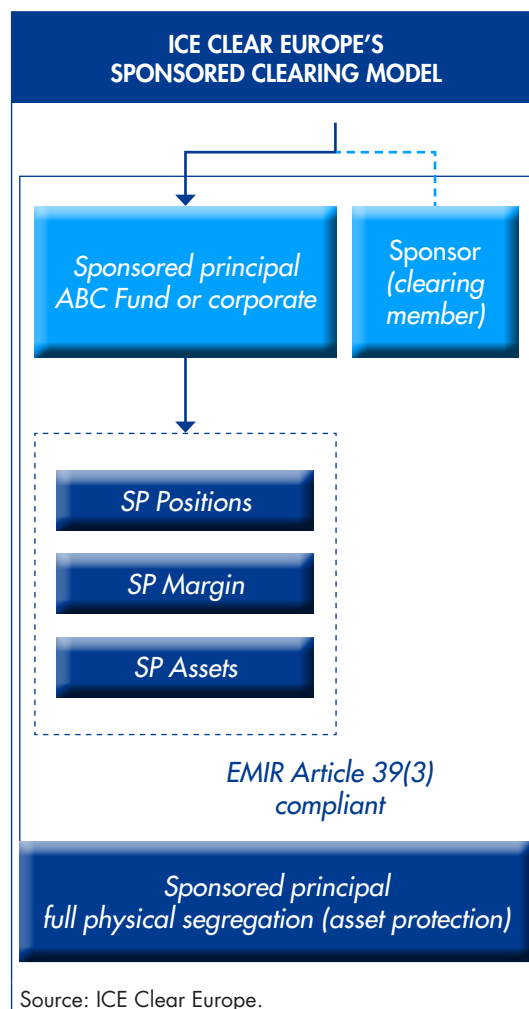
## 2 Development of new models

The increased incentives for central clearing have prompted CCPs to create direct participation models for clients, thereby reducing the impact of the leverage ratio on clearing members. This is probably being fuelled by the reduction in the supply of clearing services, and by an increased desire on the part of end-users to find solutions where their positions and associated collateral are segregated, thereby offering better protection of their assets (“individual segregation”).

Several CCPs thus offer their end-users direct access to their services, in the form of a “sponsored” arrangement whereby a clearing member acts as an agent. The sponsor is responsible for paying contributions to the default fund and managing participation in auctions in the event of a default by a third party. For clients (e. g. insurers, pension funds), this model has the advantage of allowing them to have their own individual positions in the CCP’s books, while also giving them direct access to the CCP without having to meet direct membership criteria.<sup>20</sup> In those models that do not provide for a guarantee by the agent for client transactions, the sponsor benefits from lower prudential capital requirements.

In the European Union, sponsored membership has been authorised in at least two countries and is used to date by two CCPs: ICE Clear Europe and Eurex Clearing AG. LCH Ltd has also launched a sponsored model similar to Eurex in the repo and securities lending segment.

ICE Clear Europe offers a sponsored clearing model that enables the client to segregate its assets and positions, thereby

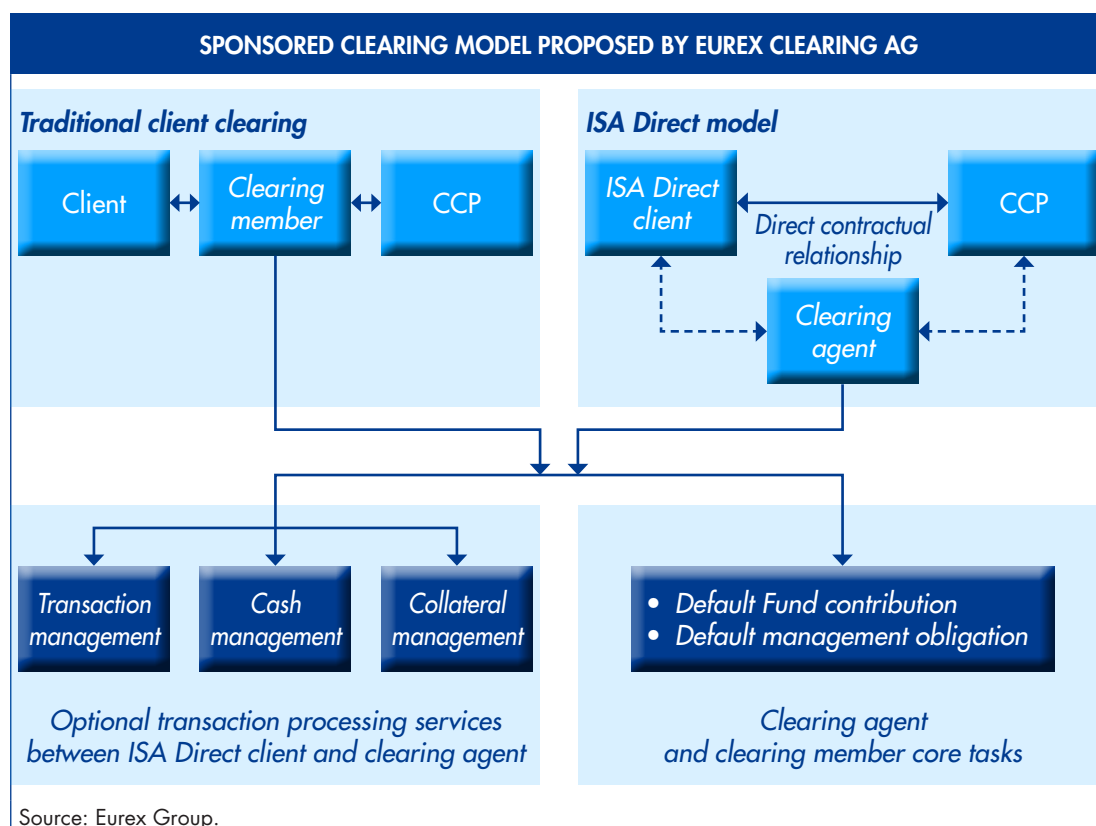


Source: ICE Clear Europe.

providing it with the same protection as an individually segregated account; the difference is that the client has a direct contractual link with the CCP. The clearing member (sponsor) is jointly and severally liable with the (sponsored) client vis-à-vis the CCP, implying that it guarantees the performance of the client’s transactions to the CCP. The margins are paid by the sponsored client, while the clearing member agent contributes to the guarantee fund and participates in the management of defaults.

Eurex Clearing AG, for its part, allows buy-side participants to be direct members of the CCP (ISA Direct Members), with the support of a clearing member acting as an agent. In this model, **the agent does not guarantee the transactions of its clients**

<sup>20</sup> Given that CCP membership involves meeting a number of financial requirements, clearing members are typically significant banks (see Introduction above “What is a clearing member?”).



**vis-à-vis the CCP, thus reducing its prudential capital requirements.** Target clients are pension funds, investment funds and insurance undertakings acting on own account only.

In the United States, there is only one sponsored model, CME Clearing, created at the end of 2016, and which is very similar to that of ICE Clear Europe. In this model, the purpose of which is to provide full segregation of client assets, the clearing member agent (direct funding participant guarantor) guarantees all the financial obligations of the client (direct funding participant) vis-à-vis the CCP.

Not all these models necessarily allow for a reduction in leverage capital requirements for the sponsoring clearing member (see below). At this stage, the main benefit for banks is with regard to securities lending

and repo activities, due to the fact that the rules for calculating exposures to these activities in the leverage ratio framework are more conservative than those for derivatives exposures.

However, some end-clients are in favour of such models as they would improve the leverage ratio of the clearing member and thus reduce prices; they also note, however, that, operationally, the establishment of such contracts takes time.

### 3 Role of the leverage ratio in these developments

The specific role of the leverage ratio in shaping developments in the client clearing market is difficult to pinpoint. However, the leverage ratio is regularly mentioned by market participants as a reason for the decline in supply.

For example, a US Treasury<sup>21</sup> report published in June 2017 estimates that a high leverage ratio discourages firms from providing client clearing services, due to the low-margin, high-volume nature of the business. According to the CFTC's estimates, quoted in the Treasury report, allowing for IM offset in the calculation of the leverage ratio would reduce banks' own funds by only 1%, while reducing the cost of this activity by 70%.

By construction, the leverage ratio's own funds requirement for central clearing activities should exceed that of the solvency ratio for a majority of banks, which will have an impact on the capital cost of those transactions. This is **an expected effect of the leverage** ratio, which was designed as a backstop to the risk-based solvency ratio. As it is insensitive to risk (and a fortiori to risk mitigation techniques), the leverage ratio is more binding than the solvency ratio for low risk activities.

However, one issue that arises is whether the incentives created by bank prudential

regulations (and in particular the leverage ratio) are compatible with the central clearing obligation.

Increasing capital constraints over recent years are often mentioned by market participants as an obstacle to the expansion of the client clearing activity, with the leverage ratio - and in particular the absence of IM offset - cited as the main constraint. Some argue that these constraints result in additional clearing costs for end-users.



#### QUESTION 3

How, in your view, have developments in the clearing market been affected by the leverage ratio?

#### QUESTION 4

Do you have analyses describing how your activities have been influenced by the leverage ratio?

21 <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>

# Prudential impact of these developments

## 1 The treatment of sponsored clearing in the leverage ratio

The impact of sponsored clearing on a clearing member acting as agent depends on the terms of the sponsorship contract and the risks to which the agent is exposed.

If the clearing member acting as agent guarantees the sponsored client's commitments vis-à-vis the CCP, it remains exposed to that client. The regulation therefore requires that the clearing member include its exposure to the client in the denominator of its leverage ratio as if it had entered directly into the transaction with the client.<sup>22</sup> However, if the clearing member does not guarantee the sponsored client's commitments vis-à-vis the CCP, it does not need to include this exposure in its leverage ratio. This treatment reflects the reduced exposure of the clearing member to the client.

In this way, the leverage ratio recognises that the "sponsored clearing" model can reduce capital requirements, provided that there is a clear prudential justification (i.e. where the agent does not guarantee the transaction). One question that arises, however, is whether the sponsor has an

implicit obligation to support the client in the event of difficulties (step-in risk). In general, supervisors need to monitor these arrangements closely and, where necessary, assess contracts to check for the presence of possible implicit guarantees, in order to avoid any undue reductions in capital requirements.

In addition, where there is no guarantee and the sponsor's exposure is reduced, the CCP is directly exposed to the client, without the additional security of the clearing member, implying (i) that the client needs to comply with the due diligence requirements and obligations associated with participation in a CCP (including initial margin payments and contribution to the default fund); (ii) a change in the risk profile of the CCP due to the fact that the client is not a credit institution or a financial institution for which the obligations associated with participating in a CCP are a usual part of its activities.

## 2 Risks to financial stability

The decline in the number of players increases the concentration of the central clearing sector and the systemic footprint of the remaining clearing members.

<sup>22</sup> Paragraph 42 of the Basel standard for the leverage ratio



According to the CFTC Chairman's speech (already mentioned above), in some exchange traded derivatives (ETD) markets in the United States, almost half of all trades are cleared by 3 or 4 clearing members. More generally, it is noted that (i) clearing members' activities are predominantly proprietary; and (ii) client clearing activities are highly concentrated. Indeed, according to an international report on central clearing interdependencies published on 5 July 2017,<sup>23</sup> although client margins on average represent, in the majority of cases, less than 5% of the total margins posted by clearing members, for the two largest members of each CCP, they account for more than 60%.

The increased concentration of the sector poses a risk to the portability of positions in times of stress. Indeed, in such situations, the margins required by CCPs increase, while banks' own funds decrease, making it harder for banks to accept positions from defaulting entities. If margins cannot be offset against transferred positions, then it is more difficult for other clearing members to accept the latter. And if the positions of a defaulting clearing member cannot be ported, the CCP will be obliged to liquidate them, with a risk of spillover effects on the markets.

Furthermore, the decrease in the supply of central clearing services reduces the hedging capacity of some clients. According to some respondents to the Basel Committee's April 2016 consultation, the worst-affected clients would be directional ones (insurance companies, pension funds, certain asset managers, sovereign counterparties and corporates) as there is limited room for netting between buy and sell positions.

In addition, as well as the issue of non-recognition of *initial* margins, which is considered detrimental, some respondents emphasise that the lack of recognition in the leverage ratio of securities *variation* margin, unlike variation margin in cash (which is regarded as a pre-settlement and thus recognised) has an impact on end-users that are structurally lenders of securities, such as insurers or some pension funds. This asymmetry could lead to an increase in the fees demanded by banks for securities collateral, or even a risk of stress in the cash repo market (since structural lenders seek cash in the repo market).

Finally, the sponsored model in which the clearing member does not provide any guarantee to the CCP, as proposed by Eurex Clearing AG, changes the risk profile of the CCP, since sponsored clients (pension funds, investment funds, insurance companies) have a different risk profile to traditional clearing members - some (e. g. insurance companies) have a directional risk profile, while others (e. g. non-financial corporations) are not supervised. In respect of the required collateral, clients may have assets that are not all eligible with the CCP, whereas a clearing member would be able to transform those assets. In addition, responsibility for assessing clients with direct access to the CCP is transferred to the CCP, as is the management of client defaults. "Sponsored" clients also have to deal with risks related to direct participation in a CCP but which are not necessarily adapted to their user profile. For example, for a sponsored client with directional positions, participating in OTC derivatives auctions to take on the positions of another CCP participant in the event of a default could be problematic.

<sup>23</sup> BCBS, CPMI, FSB, IOSCO, [Analysis of Central Clearing Interdependencies, 5 July 2017](#) (analysis based on data collected from 25 major clearing members of 26 different CCPs).

# Options for the regulatory treatment of initial margins received by clearing members under the leverage ratio

From a prudential perspective, an exception to the non-recognition of initial margins in the leverage ratio could be explored in cases where the clearing member cannot use the initial margin received as leverage, so that the principles underlying the leverage ratio would be partly met. For example, this may include initial margins transferred by the clearing member to the CCP for the clearing of its client's positions, where the clearing member acts as a pass-through, without the collected margins being used to increase its leverage (to the extent that the clearing member would not be contractually required to reimburse the client for losses due to the CCP defaulting as provided in paragraph 41 of the Basel standard). Similarly, initial margins may, in some cases, be segregated or passed on to a third party (e. g. a custodian) so that they cannot be re-used by the clearing member, even though they would still appear on its balance sheet.

Therefore, if the leverage ratio treatment of initial margins received by clearing members were to be revised, two broad options could be considered: the application of the unmodified SA-CCR, with full recognition of initial margins from clients (**Option 1**), or a limitation of such recognition to initial margins that cannot be re-used by the clearing member (**Option 2**).

## **Option 1 – Pure and simple recognition of initial margins from clients**

This option would have the advantage of unambiguously eliminating any binding effect of the leverage ratio on client clearing activities, thereby reducing the potential unintended effects of the measure discussed above (sector concentration, access difficulties for end-clients, etc.). It is also a simple solution that applies the SA-CCR as it is used for the solvency ratio. Conversely, this option would have the disadvantage of introducing an exception to the principles underlying the leverage ratio.

## **Option 2 – Recognition limited to the amount of initial margins that cannot be re-used by the clearing member (e. g. margins segregated in a way that prevents reuse or margins posted to a third party, CCP or custodian)**

This proposal could be made conditional on the absence of a contractual obligation for the clearing member to reimburse the client for losses due to a default by the third party to which the margins have been transferred (reflecting the model described in paragraph 41 of the Basel standard).

This would have the advantage of remaining largely faithful to the principles underlying

the leverage ratio, to the extent that the initial margin received is not used to increase the leverage of the clearing member. In parallel, it could potentially encourage some harmonisation in the calculation of initial margins by incentivising clearing members to develop individual segregation models (both in terms of the individualisation of positions and assets deposited as collateral), which typically cost more in terms of implementation for the end-user, even though they are more secure for the client.

However, it could potentially lead to higher costs for client clearing activities and affect conditions of access to this service.

Furthermore, this solution would be complex to implement due to several technical difficulties. In particular, it requires defining common international criteria to assess the non-reusable nature of initial margins, which seems difficult given the existing differences in the accounting recognition of initial margins received and segregation. Similarly, in the case of margins posted to a third party, it would be potentially difficult to determine the amount to be deducted for margins that are not segregated individually, while differences in nature and quality usually exist between the margins received from clients and the margins transmitted to the third party by the clearing member. In the case of a third party that is a custodian, a condition whereby the clearing member is not required to guarantee to its client the performance of the third party to which the initial margin is transferred would create an additional custody risk. But this would be very unusual in practice, as segregation is designed precisely to allow the client to recover posted margins. Finally, such a solution would not necessarily incentivise clearing members to calibrate margins in a conservative manner.

## Other technical aspects

Aside from the issue of re-using initial margins, there is also the question of whether a distinction should be made between cash and securities initial margins. In this respect, accepting all types of initial margin would allow full alignment with the applicable solvency framework. However, recognising initial margins only when they are paid in cash, as with the treatment of variation margins in the leverage ratio, would be more prudent as such margins are more liquid and portable, but would create a distorting effect in the leverage ratio in favour of cash.

Finally, there is also the question of whether initial margins should be recognised at the level of the PFE only (as envisaged in the ongoing BCBS review) or in the RC and the PFE (as envisaged in the European Commission's CRR 2 proposal). Recognising initial margins at the level of the PFE would only limit the derogation. But recognising initial margins at the replacement cost (RC) and PFE level would be more consistent with the SA-CCR approach, with initial margin affecting both components.



### QUESTION 5

What benefits do you see in Options 1 and 2 respectively?

### QUESTION 6

Should there be a distinction between cash and securities initial margin?

### QUESTION 7

To what extent should the recognition of initial margins be applied?

## Conclusions

The work carried out by the Banque de France and the ACPR suggests that banks have observed an increase in demand for clearing services in recent years, in particular due to regulations and new clearing obligations, and that some banks seem to be able to cope with this.

However, there are signs of market stress. While Basel III is not the only reason for this - there has been a trend towards consolidation in the client clearing market since the beginning of the 2000s - there have been a number of withdrawals from these activities in recent years, leading to greater sector concentration and an increased risk of non-substitutability. Banks' sensitivity to the cost of central clearing is being felt by end-users in the form of higher prices, a reduced scope of accepted collateral, or additional pressure for netting and compression of transactions. At the same time, CCPs are developing direct participation models for clients, in particular

to address demand increases and reduce the impact of regulation for clearing members.

The role of the leverage ratio in these market developments is difficult to assess, although the ratio is regularly cited by the participants as a factor behind the decline in supply, alongside other prudential ratios such as the NSFR.

The tensions observed pose a risk to financial stability. Indeed, increased sector concentration poses a risk to the portability of positions in the event of a default by a clearing member. Moreover, the decrease in supply reduces the hedging capacity of some clients, with the worst-affected being a priori directional ones (insurance companies, pension funds, asset managers, sovereign issuers, non-financial firms). Finally, the sponsored model in which the clearing member acting as agent no longer provides a guarantee for the transaction changes the risk profile of the CCP.