



July 6, 2016

Bank of International Settlements
Secretary
Basel, Switzerland

RE: Comments on Consultative Document: Revisions to the Basel III Leverage Ratio Framework

To Whom It May Concern,

Americans for Financial Reform (“AFR”) appreciates the opportunity to comment on the above-mentioned Consultative Document. AFR is an American civil society coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.¹

Among other issues, this Consultative Document proposes to change the measurement of derivatives risk exposures for leverage ratio purposes by replacing the Current Exposure Method (CEM) used today with the Standardized Approach to Counterparty Credit Risk (SA-CCR). The document implies that the SA-CCR has a more realistic approach to risk measurement, while the CEM is more conservative.

We believe that derivatives risk exposures are already measured in a manner that is excessively generous and does not take adequate account of tail risks, even under the current use of the CEM. For example, the latest derivatives report from the U.S. Office of the Comptroller of the Currency (OCC) shows under the CEM method, U.S. regulators measure only \$1.1 trillion in credit exposure for the \$193 trillion in total derivatives notional value within the U.S. banking system.² Under the 5% leverage ratio required under U.S. rules, this means that only \$50 billion in total capital is required against this \$193 trillion in notional value; using the 3% Basel leverage ratio some \$30 billion in capital would be required. So under current Basel rules requiring three percent of CEM exposure, leverage capital held against derivatives would be just 1.6 basis points, or less than one-fiftieth of one percent, of total notional value.

We understand that notional value overestimates likely derivatives exposures, but it is at least possible that some non-trivial fraction of notional value could materialize as additional credit exposures in a stressed market scenario. History demonstrates the risks of being unprepared for such a scenario. As the financial crisis materialized, over the period from December 2006 to

¹ A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

² Office of the Comptroller of the Currency, “Derivatives Trading Report: First Quarter 2016”, U.S. Department of the Treasury, June, 2016. Available at “<http://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq116.pdf>”

December 2008, derivatives credit exposures more than doubled, from \$2 trillion to \$5 trillion.³ The sudden appearance of some \$3 trillion in additional credit exposures due to derivatives was a major factor in the global loss of confidence in the soundness of the financial system.

Given the currently extraordinarily low level of leverage capital required to support the derivatives business, it is remarkable that the BIS appears focused on ways to lower capital requirements still further. Yet this would be the likely effect of the proposal in this Consultative Document. The SA-CCR is a very different methodology conceptually from the CEM. In some cases, for some exposures (such as those in which netting sets contain dissimilar exposures that would not qualify for hedging benefits under the SA-CCR), the SA-CCR could result in increasing capital requirements. Yet the overall effect of the SA-CCR is like to be less overall capital held against derivatives risks – especially once major dealers act to optimize hedging benefits permitted under this methodology.

This is true for several reasons:

- Unlike the CEM, the SA-CCR does not incorporate a measurement or add-on that reflects the gross total size of derivatives exposures. Instead, it permits full netting of exposures, on the assumption that closeout netting will function perfectly in bankruptcy – an assumption that is doubtful given past experience.⁴
- The SA-CCR models future exposures using historical variability in derivatives prices, in a manner that could make capital requirements larger and more realistic than the CEM on an individual trade level. However, the SA-CCR also permits hedging benefits between broadly similar exposures that are likely to drastically reduce capital charges. Large derivatives dealers who attempt to maintain a roughly balanced book could take advantage of these hedging benefits to greatly reduce their overall capital requirements. But predicted or modelled hedging benefits can be highly unreliable in stressed markets, in ways that are difficult to predict in advance.
- While the version of the SA-CCR proposed here does not explicitly offset exposures with initial margin, it permits a much shorter Margin Period of Risk (MPOR) for margined exposures. As the Consultative Document states, this is effectively equivalent to recognizing margin benefits.⁵

AFR, like other members of the public, has not been able to examine in detail the results of the Quantitative Impact Study (QIS) that the Bank of International Settlements has conducted on the

³ Bank of International Settlements, Semiannual Derivatives Statistics, Available at <http://www.bis.org/statistics/derstats.htm>

⁴ Lubben, Stephen J., Lehman's Derivative Portfolio (December 2, 2015). Seton Hall Public Law Research Paper. Available at SSRN: <http://ssrn.com/abstract=2698234>

⁵ See Page 3 of the Consultative Document, which states that “taking into account the shorter time horizon for MPOR results in a significant decrease in CMs’ PFE, whereas potential recognition of offsets of IM against PFE in line with the unmodified SA-CCR calculation would not further decrease the amount of CMs’ PFE substantially.”

use of the SA-CCR vs the CEM. But we believe that the results of this QIS would support the contention above that the SA-CCR will lower capital requirements significantly.

Other choices in this Consultative Document will also tend to reduce derivatives capital requirements. For example, the BIS proposes to permit companies not to consolidate derivatives exposures at certain subsidiary Clearing Members (CMs) provided that the parent bank does not explicitly guarantee the performance of the subsidiary. Regardless of what is told to regulators, it seems highly unlikely that clients would clear through a bank subsidiary clearing member if they were not confident that the bank would support performance of the derivative. The bank would lose significant market confidence if they let their subsidiary fail to perform to its clients. This argues for recognizing such relationships as part of the consolidated derivatives commitments of the parent bank.

We urge the BIS to reconsider its current approach. International regulators should not facilitate the ability of major derivatives dealers to reduce the capital that supports their derivatives operations. More realism can be introduced to the CEM approach without permitting hedging and margin allowances that are likely to reduce current derivatives capital. We believe that a more realistic approach should also be oriented toward using strong market stress assumptions (including an add-on for gross derivatives exposures) and should act to increase the capital devoted to supporting the global derivatives market from its current low level. This Consultative Document goes in the wrong direction.

Thank you for the opportunity to comment on this Consultative Document. If you have any questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Americans for Financial Reform