Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
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Dear Sir/Madam:

Re: Comments in Response to the Consultative Document on Revisions to the Basel III Leverage Ratio Framework

Introduction and overview

The Global Financial Markets Association (GFMA), the Institute of International Finance (IIF), International Swaps and Derivatives Association (ISDA), Japan Financial Markets Council (JFMC) and The Clearing House (TCH), collectively "the Associations", represent the largest participants in national and global banking and financial markets. The Associations appreciate this opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) April 2016 Consultative Document, Revisions to the Basel III leverage ratio framework (Proposed Framework).

The Associations remain supportive of BCBS's efforts to impose the leverage ratio (LR) as a simple, transparent and non-risk-based backstop to the risk-based requirements. While the risk-based requirements are intended to be the binding requirements for most banks in order to effectively correlate their capital levels with the actual risks they take, the LR's objectives are to 1) ensure that an appropriate minimum level of capital is held at all times in the event that the risk-based measure fails to capture certain risks and 2) restrict build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy.

We commend the BCBS for consulting on various issues that improve the harmonization of the exposure measure, take into account developments elsewhere in the regulatory agenda and acknowledge that accounting treatment of certain assets may not be appropriate for prudential regulation and the LR framework. However, many of the changes to the framework contemplated in this consultation paper may further increase the number of firms that allocate capital according to the non-risk based LR rather than the risks associated with the business activity. We provide our detailed feedback and recommendations in this response with a view to

help the BCBS to capture real leverage and to achieve better consistency of the leverage exposure measure.

While this letter focuses on detailed comments and recommendations on topics raised in the consultation document, we would firstly like to highlight a few key issues that the BCBS should consider in its iterations regarding the design and calibration of the LR within the overall regulatory framework.

Incentives driven by capital allocation

As can be seen from the BCBS and EBA Basel III monitoring exercises, the LR is already the binding capital constraint to a large number of firms. If the majority of firms become constrained by a measure of capital adequacy that does not differentiate between low and high risk assets, it will fundamentally change the way banks allocate capital to business lines, with subsequent changes to pricing and availability of products that are vital to functioning of the global economy. For firms already bound by the LR, these changes can lead to a significant increase in overall capital requirements that are not at all rooted in the risk profile of an institution.
Additionally, should the LR be calibrated in a way that divorces binding capital constraints from risk, it would create incentives for banks to reallocate capital to higher yielding and riskier assets in an effort to generate shareholder returns. While regulatory requirements such as the LCR and NSFR mandate the holding of substantial quantities of low-yielding assets, these assets are "taxed" through the LR, providing strong incentives to banks to "barbell" their portfolios. If a majority of banks react in this way, it would undoubtedly increase systemic risk throughout the financial system.

Treatment of cash and cash equivalents

A stated purpose of the LR is to avoid contributing to the vicious cycle of "fire sales" of certain types of assets during periods of market stress. Cash does not fall into this category and on the contrary, in times of economic stress, customers tend to flood the banking system with deposits rather than deploy their resources in riskier assets. Banks have little control over their balance sheets, including for custody banks that maintain the primary operational accounts of institutional investors with large and diversified global investment portfolios, when customers choose to deposit cash rather than invest in other assets. In this context, we note that on 5 July the Bank of England's Financial Policy Committee published the conclusions of its review of its leverage ratio framework in its Financial Stability Report[1]. The FPC

[1] http://www.bankofengland.co.uk/publications/Documents/fsr/2016/fsrjul16.pdf

expressed strong concerns regarding the inclusion of central bank cash balances in the leverage ratio, noting that "there is no direct benefit to funding holdings of reserves with capital" and that their inclusion in the leverage can "affect the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities, as necessary, to maintain the supply of credit and support for market functioning". The industry shares FPC's concerns.

Similarly, cash and high quality government bonds are used as collateral by most market participants for central clearing and other financing transactions and as liquidity reserves by small and large banks, investment funds and corporates. They play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired due to constraints on bank balance sheet capacity, particularly during stress periods, it will have ramifications for the functioning of financial markets.

Cumulative impacts on wholesale market activity

Regulations that are risk-insensitive, and regulations that target the same risk multiple times through multiple rules, weigh particularly heavily on these low-risk and risk free assets. For example, while high quality government bonds receive a 3% capital charge under the LR, the NSFR imposes a 10% funding charge on reverse repos, making it difficult to provide financing against cash-equivalent assets. This is just one example where conflicting regulatory costs (estimated from 60bp to 110bp) in low margin market making activities are extremely detrimental to the market liquidity of instruments that facilitate financing of governments worldwide. Many banks that used to be substantial liquidity providers in this and other products have announced their withdrawal from these businesses[2].

Bearing in mind these broad systemic safety concerns, we strongly encourage the BCBS to consider carefully the way cash and unencumbered cash equivalent assets are treated in the LR. In addition, we recommend that the interaction of the LR and the liquidity rules is a particular focus area in the BCBS's coherence and calibration work programme.

Against these broader concerns, our response below sets out in detail the changes and recommendations that we consider necessary in order to capture the real underlying leverage exposures, but we would highlight in particular the following points:

[2] http://www.pwc.com/gx/en/banking-capital-markets/pdf/pwc-supplementary-report-2.pdf

1. We recognise the possible need for an additional LR buffer requirement for G-SIBs, reflecting the additional risk based G-SIB buffer requirement, if the QIS suggests that such a requirement is necessary for the LR to perform its function as a backstop. But it is important from a financial stability perspective that any such additional requirement be set as a buffer that can be utilised as necessary without automatic consequences.
2. We recommend that the BCBS adopts option B on netting for regular-way purchases and sales of financial assets. Option A would produce an artificial "ballooning" of the bank's balance sheet, increase volatility in the exposure measure and constrain banks' ability to execute client orders. This would be an undesired outcome with a significant impact on broader market liquidity, while not addressing a real leverage concern. Delivery-versus-payment settlement ensures that, at all times, the bank has either the security or the cash associated with buying or selling that security.
3. Certain notional cash pooling arrangements are treated as a single unit of account for accounting purposes across the accounting standards. Under such circumstances, a single amount is owed to or from the client entity (or the group of affiliated client entities) subject to the Pooling Agreement. We believe that the LR treatment should follow accounting under these conditions to avoid unnecessary damage to banks' ability to provide these important cash management products to their clients.
4. The Associations recognise the need for simplicity and that treatment of credit conversion factors (CCF)s in the LR should in principle be aligned with the credit risk framework. However, as noted in the industry response[3] to the second consultation on revisions to the standardized approach for credit risk and a subsequent TCH study[4], the current proposals are in most cases disproportionate and would lead into significant increase in capital requirements under the credit risk framework, and similarly in the context of the LR.
5. Some of the proposals, such as the 1.4x alpha factor in SA-CCR, introduce risk based concepts without clear justification. Whilst the risk based capital is determined on a portfolio-based level and requires consideration for correlation or diversification, the replacement cost (RC) component of the

[3] http://gfma.org/initiatives/basel-iii/gfma,-isda,-iacpm-and-jfmc-respond-to-the-basel-consultation-on-internal-risk-models/

[4] https://www.theclearinghouse.org/issues/articles/2016/03/20160316-tch-comments-to-basel-committee-on-standardized-approach-to-credit-risk

LR exposure is a simple sum of balance sheet exposures. We therefore do not believe that the 1.4x alpha factor should be applied to RC in the LR framework.

6. The industry welcomes the decision by the BCBS to consider recognising the exposure-reducing effect of initial margin (IM) for client cleared transactions. In our view, the current framework significantly overstates LR exposure with detrimental effects on client clearing businesses. The LR framework should recognize the exposure-reducing effect of IM for cleared derivatives transactions.
7. Non-cleared transactions suffer from conflicting regulatory objectives. For leverage ratio, the mandatory IM requirements have the effect of increasing the LR exposure without any reduction in the potential future exposure calculation. We believe this is inconsistent with the objectives of the margin requirements to establish a robust regulatory framework whereby non-centrally cleared derivatives are bilaterally collateralised and subject to either margin or capital requirements. In our view, not recognising the exposure-reducing effect of IM overstates leverage on a system-wide basis.
8. Banks' inability to offset the replacement cost in OTC derivatives exposures with high quality liquid assets (HQLAs) received as variation margin (VM) incentivises banks to receive cash VM. Without changes to the way these cash equivalent assets are treated in the LR VM exposure measure, pension funds and other end-users that rely on the ability to post securities as collateral, will instead post cash as VM. Such end users often use derivatives to manage their financial solvency and could, as a result of such treatment, abandon the use of derivatives as hedging instruments or be forced to post cash VM resulting in significant cost and liquidity risk.
9. A well-calibrated LR which recognizes the benefits of securitization for originating banks can be both prudent and help meet global and regional policy objectives of reviving the securitization market in order to support growth and the real economy. Where a bank securitizes assets in a traditional securitization by placing tranches of that securitization with unaffiliated third party investors, without recourse to or where there is no repurchase obligation by the bank, the bank should be permitted to not consolidate the SPV in the regulatory consolidation perimeter, and for the purpose of calculating its LR it would include only those tranches which it retains.

The Associations' recommendations on these key priority and other topics are described in more detail in the remaining sections of this comment letter. We

appreciate your consideration of our proposals and we remain at your disposal in the development of the LR framework.

Yours faithfully,

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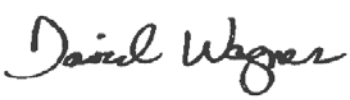

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Introduction and overview 1

1. GSIB buffers 8
2. Trade date/settlement date accounting 9

I. The Committee Should Adopt Option B, with Modifications 10

II. The Basel Committee Should Amend the Proposed Conditions of Option B 17

3. Cash pooling 21
4. Credit conversion factors (CCFs) 23
5. SA-CCR's Replacement Cost in the LR 24
6. Recognition of Initial margin (IM) for cleared and uncleared derivatives 26
7. Recognition of high quality government bond securities to offset replacement cost in OTC derivatives exposure calculation 28
8. Securitizations 30
9. Secured Financing Transactions (SFTs) 36

Open-ended repos 37

SFT double counting 37

10. PFE calculation for cleared transactions (CCP facing legs) 38
11. No haircut should be applied to cash variation margin (CVM) exchanged 38
12. Reduction of the effective notional amount of a written credit derivative – condition on the strike of purchased options 41
13. "Connected or Correlated Counterparties" criterion should remain simple 45
14. "Same Material terms" criterion is restrictive 46
15. LR impact for inter-company clearing exposures should be assessed regionally 46
16. LR implications of the new lease standards 47

1. GSIB buffers

The consultation seeks views on the characteristics for an additional GSIB requirement in order to propose a minimum global standard for leverage, comparable to the risk-based GSIB capital framework. Our understanding is that this is based on the same logic applied by certain local competent authorities – to keep the LR as a meaningful backstop to the risk based GSIB measure for large banks.

We strongly suggest that the BCBS should continue setting reasonable minimum standards that are appropriate for all major markets. Therefore, the BCBS should take into account divergent regional financing structures and bank balance sheet compositions and only apply GSIB LR buffers if the QIS data indicates that the LR does not perform its role as a meaningful backstop across jurisdictions and if such buffers can be applied without significant damage to broader markets and availability of key financing products.

Ahead of an agreed global framework, certain local competent authorities have already implemented additional measures, mainly based on the requirements of the local financial system. A type of straightforward way of calculating additional GSIB buffers according to the 'bucket', or in other words by scaling the buffers according to size could be used as a method for applying GSIB buffers, bearing in mind BCBS's mandate to set minimum capital requirements that work for all jurisdictions.

It is crucial that any GSIB leverage buffer is a genuine buffer, not an increase in the hard minimum LR requirement for GSIBs. Adding to the hard minimum LR requirement would risk rendering at least part of the risk-based buffers unusable if the amount of CET1 required to meet the LR requirement exceeds the amount required to meet the risk-based minimum. This could, amongst other things, limit the practical usefulness of the risk-based countercyclical buffer as a macro-prudential tool.

We strongly agree with a feature of the UK PRA leverage framework, whereby any entry into a CET1 leverage buffer does not have automatic consequences, such as the application of mandatory distributable amounts (MDAs) or the conversion of AT1 instruments to CET1. Introducing automatic consequences for breaching GSIB leverage buffers would add unnecessary and counter-productive complexity into the framework, and an increase in the "uncertainty premium" particularly where a firm enters a period of stress. This would run directly contrary to the leverage regime's objectives, and could be pro-cyclical.

A more appropriate response to any use of the LR GSIB buffer would be for supervisors to be expected to take timely and appropriate action to ensure that the

use of the LR GSIB buffer is temporary. Given that the LR regime should function as a backstop to the risk-based regime, it is likely that the risk-based buffers would in any case be entered before or concurrently to the LR GSIB buffer. This approach allows supervisors and firms to focus on their responses to any entry into the risk based buffer, without the unhelpful interference of LR buffer consequences.

2. Trade date/settlement date accounting

The Proposal would revise the calculation of leverage exposures attributable to a bank's regular-way purchases and sales of financial assets such as securities so that differences in the accounting treatment of such trades in different jurisdictions – that is, differences in recognition of purchases and sales based on "trade date accounting" vs. "settlement date accounting" as well as differences in netting of related cash receivables and payables between the trade and settlement date – do not create differences in leverage exposures across jurisdictions. To achieve this goal, the Proposal sets forth two options for revising the treatment of these transactions:

- **Option A** would require all banks to recognize in the LR denominator the purchases and sales of financial assets at trade date, but without any recognition of an offsetting reduction of the cash receivables for sales of such assets by the cash payables for purchases of such assets. To achieve this result, Option A would require a bank using settlement date accounting to treat unsettled financial asset purchases as of trade date as off-balance sheet items subject to a 100 percent CCF. This would substantially increase the size of the banks' denominator as of trade date. With respect to banks using trade date accounting, Option A would require a bank to reverse any offset permitted at trade date under its applicable accounting standard of cash payables against cash receivables associated with financial asset purchases and sales; this, too, would have the effect of substantially increasing the size of its denominator at trade date.

- **Option B** would require all banks to recognize in the LR denominator the purchases and sales of financial assets at trade date, but with recognition of an offsetting reduction of the cash receivables for sales of such assets by the cash payables for purchases of such assets. To achieve this result, Option B would require a bank using trade date accounting to offset cash payables against cash receivables associated with financial asset purchases and sales, which is currently permitted under accounting standards in some jurisdictions but not others. Option B would further require a bank using settlement date accounting to change its calculation of its LR exposure for financial asset purchases and sales in an unspecified way to achieve "an

equivalent effect" as the calculation of such transactions for banks using trade date accounting.

For the reasons discussed below, we strongly urge the Committee to adopt Option B, with certain modifications to Option B's proposed conditions and to its application to banks using settlement date accounting.

I. The Committee Should Adopt Option B, with Modifications

Option A Would Substantially Overstate Banks' Actual Economic Exposure in Delivery-Versus-Payment Transactions

DvP settlement systems emerged in response to concerns that parties in securities transactions were potentially exposed to the loss of cash or securities delivered at settlement if their counterparties failed to perform. In a worst case scenario, the performing party would deliver its assets without receiving the contractually agreed assets in return, leading to a total loss. These concerns have been a focus of the Bank for International Settlements ("BIS") for nearly three decades. As noted by the BIS in a 1992 report, "[w]ithout such a mechanism (delivery versus payment) counterparties are exposed to principal risk, that is, the risk that the seller of a security could deliver but not receive payment or that the buyer of a security could make payment but not receive delivery."[5] DvP mechanisms solve for this exposure problem by making each party's performance contingent on its counterparty's performance; as a result, each party remains exposed to its original assets until settlement is completed, at which point each party is exposed to its new position.

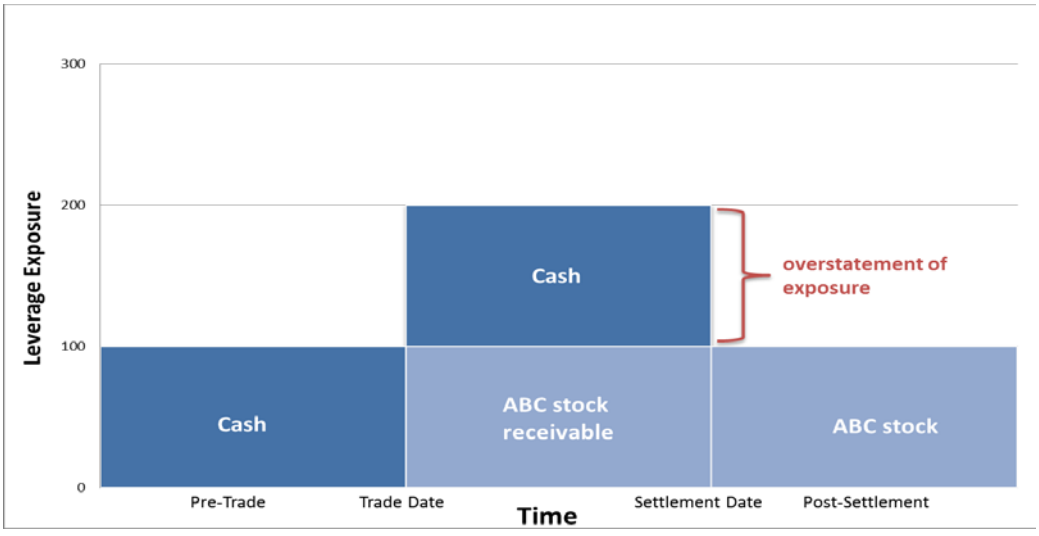
Accordingly, DvP settlement ensures that, at all times during the life of a trade, a bank has either the security or the cash associated with buying or selling that security; as a result, there should be no reason to artificially inflate the amount of the leverage exposure beyond the value of either the security or the associated cash. For example, if a bank agrees to sell a security for cash, at all times it will either own the security or receive the cash; that is, if the buyer fails to provide the cash the bank will still have the security. Likewise, if a bank agrees to buy a security for cash, at all times it will either have the cash or receive the security; that is, if the seller fails to provide the security, the bank will still have the cash. In short, as a result of DvP, the bank will never have both the security and the cash associated with buying or selling

[5] BIS, *Delivery Versus Payment in Securities Settlement Systems* (1992), p. 3. As noted in the report, there remain market and liquidity risks inherent in all securities transactions, notwithstanding DvP settlement mechanisms. These risks, however, are not relevant for purposes of determining a bank's leverage ratio exposure.

that security at the same time, and it will never have neither the security nor the cash – it will always have one or the other.

Notwithstanding this fundamental characteristic of DvP transactions, Option A would at times require the bank to maintain LR capital against both the security and the cash associated with buying or selling the security, as though the bank were exposed to losses on both the security and the cash at the same time. For example, where on the trade date a bank commits to buy a security for $100 in cash, Option A would require the bank to treat the $100 security as an exposure for LR purposes, while at the same time continuing to treat the $100 in cash it will use to pay for the security as an exposure for LR purposes. This would create a $200 exposure for the transaction, even though, due to DvP, the bank will never own both the $100 in cash and the $100 security at the same time. Figure 1 depicts how Option A would result in an overstatement of exposure for a purchase of $100 of ABC stock by a bank using trade date accounting during the period between trade date and settlement date (and through the use of credit conversion factors, the same result would apply to a bank using settlement date accounting).[6]

Figure 1 - Option A: Leverage Exposure Treatment of Purchase of Security for Trade Date Accounting Bank

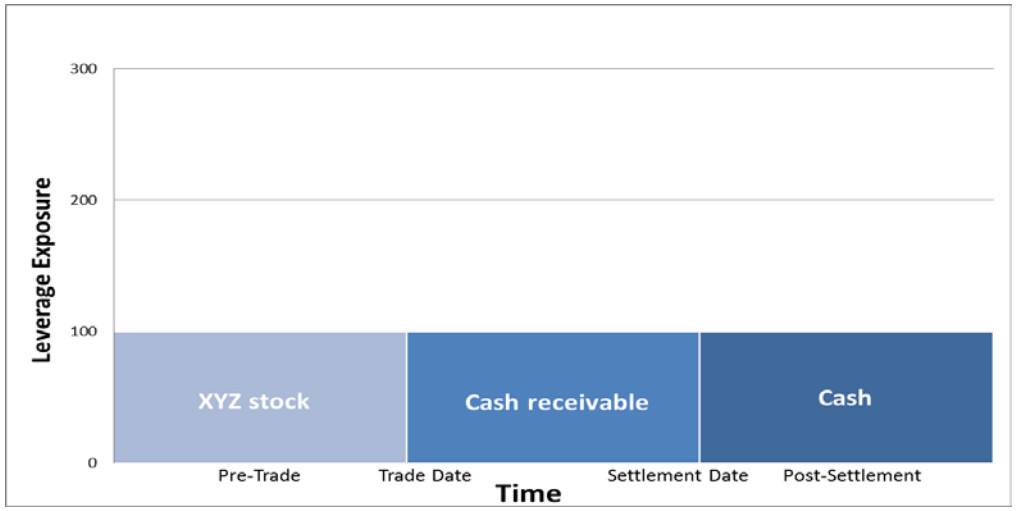


In contrast, as depicted in Figure 2, a sale of securities under Option A would produce the correct measure for actual economic exposure during the period

[6] The charts that follow depict each transaction's leverage exposure for purposes of the denominator of the LR, which for these purposes is focused on the asset side of the balance sheet; they do not attempt to depict all the credits and debits that would be made to both assets and liabilities in order to record the transaction for accounting purposes.

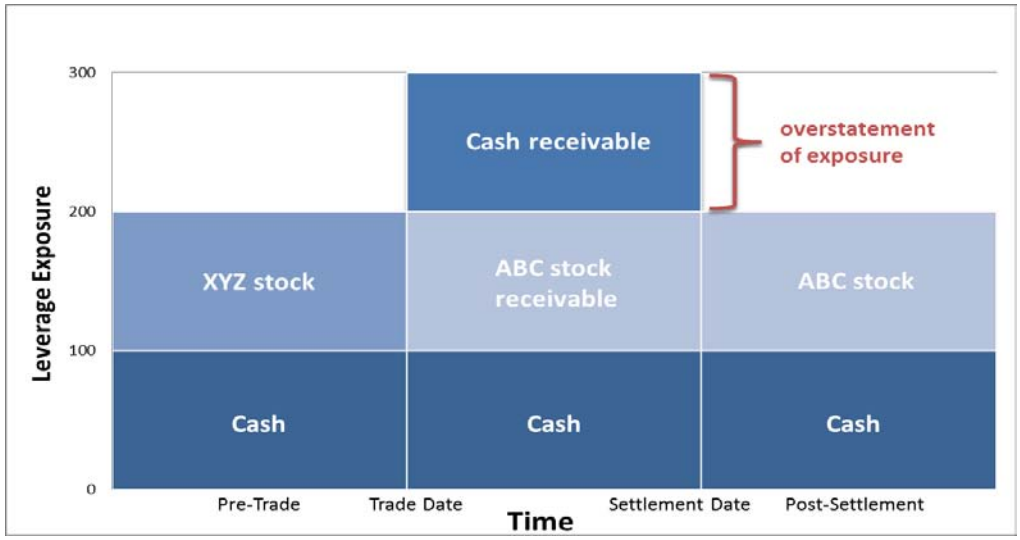
between trade and settlement (but only when viewed in isolation from the treatment of purchases, as described above).

Figure 2 - Option A: Leverage Exposure Treatment of Sale of Security for Trade Date Accounting Bank



Together, simultaneously pending sales and purchases produce an overstatement of exposure under Option A because of the artificially inflated treatment of asset purchases. Figure 3 depicts the proposed LR exposure for a simultaneously pending purchase of $100 of ABC stock and sale of $100 of XYZ stock:

Figure 3 - Option A: Leverage Exposure Treatment of Purchase and Sale of Securities for Trade Date Accounting Bank



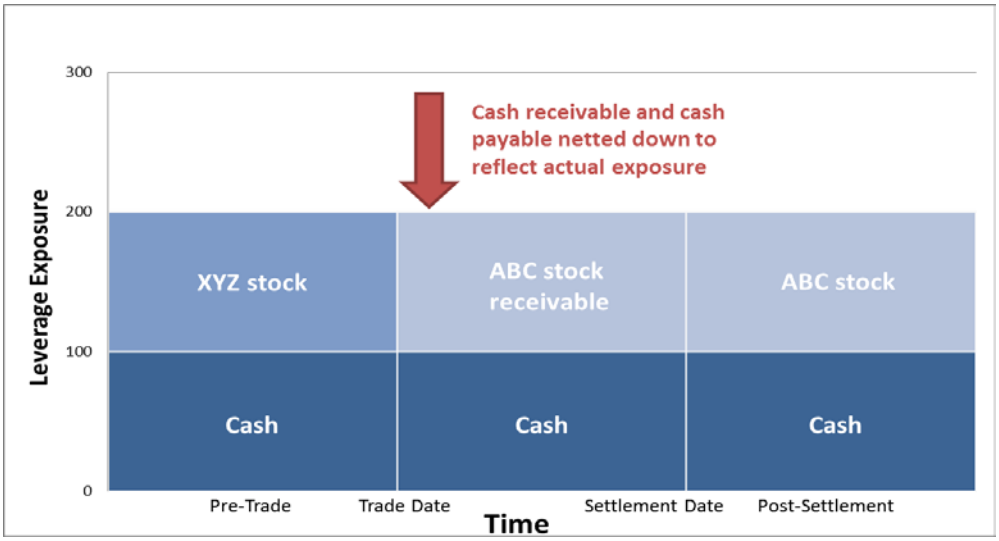
As Figure 3 shows, Option A would produce an artificial "ballooning" of the bank's balance LR exposures and therefore a substantial overstatement of actual economic

exposure during the period between trade and settlement. Further, under Option A there would be large day-to-day swings in the leverage exposure for any bank that engages in a substantial amount of securities trading activities, since the bank's leverage exposure would change significantly over the life of particular trades.

Option B solves this problem by allowing banks using trade date accounting to offset the cash payable attributable to pending securities purchases against cash receivables attributable to pending securities sales. Option B would also allow banks using settlement date accounting to replicate the effect of this treatment for banks using trade date accounting (though a specified way, as discussed below). Assuming that the dollar values of the bank's total unsettled purchases and total unsettled sales are roughly equal, the offset allowed under Option B would appropriately produce little to no overstatement of actual economic exposure in the denominator of the LR.

Figure 4 depicts the leverage exposure under Option B of a purchase of $100 of ABC stock and a simultaneous sale of $100 of XYZ stock by a trade date accounting bank:

Figure 4 - Option B: Leverage Exposure Treatment of Purchase and Sale of Securities for Trade Date Accounting Bank



The offset permitted in Option B reflects the economic reality of how the bank's balance sheet looks before the trades and how it will look after pending trades settle, and therefore prevents the substantial overstatement of exposure that is produced under Option A. As the Proposal recognizes, such an offset also recognizes the very temporary nature of any exposure sought to be captured (given the short period between trade and settlement).

Option A Would Be Inconsistent with a Key Stated Rationale for the LR

In the derivatives context, the Committee's key stated rationale for disallowing an offset to leverage exposure for collateral such as margin is that doing so could "increase the economic resources at the disposal of the bank," allowing the bank to "leverage itself."[7]

By analogy, treating both the security and the cash receivable in an unsettled asset sale as distinct LR exposures, as Option A would do, assumes that there are two distinct pools of "economic resources" available to the bank to "leverage" during the period pending settlement. That is not so, however. Neither cash receivables attributed to unsettled financial asset sales nor the securities associated with financial asset purchases can be "leveraged" in the same manner as other forms of collateral. That is, banks cannot and do not pledge or otherwise re-hypothecate trade date receivables to meet their other obligations. As a result, it would not be appropriate to require an artificial overstatement of leverage exposure to account for an unsettled purchase or sale of a financial asset that settles on a DvP basis.

Option A Would Adversely Impact Market Liquidity and Increase Systemic Risk

By artificially ballooning a trading bank's leverage exposure, Option A would create yet another significant disincentive for firms to engage in securities trading activities. As an example, if a bank were required to gross up its leverage exposure measure by $100 billion under Option A, an additional $3–5 billion of Tier 1 capital would be required (assuming a 3–5 percent binding LR requirement), which would require an additional $300–500 million of post -tax income (more in pre-tax earnings) for the bank to meet a 10 percent return-on-equity hurdle. Regular-way securities dealing is a relatively low margin business. The marginal returns of additional trades would not cover the increase in cost of capital, and as a result, the bank would be disincentivized to facilitate customer trading. At a time when there are clearly concerns about the adequacy of market liquidity, such a disincentive needlessly runs the risk of aggravating liquidity concerns.

Option A would particularly impact the market for securities with a higher share turnover velocity, that is, securities that the bank trades more frequently relative to the size of the bank's balance sheet inventory of the particular security, such as sovereign debt securities. For those securities, a bank is more likely to have many trades pending simultaneously, and therefore, a larger overstatement of leverage exposure under Option A. Furthermore, these additional capital costs of every single

[7] LR ¶ 22.

transaction in securities and would have to be passed on, reducing appetite and volumes and thereby impacting liquidity.

These adverse effects on market liquidity would be amplified in times of stress, especially for those firms for which the LR is or would be the binding constraint. Indeed, if the Committee adopted Option A, to the extent such a firm's capital were at or near its minimum LR requirement, one of the easiest and most likely methods for the firm to decrease its leverage exposure would be to cease facilitating customer transactions. Such an incentive for banks to cease providing liquidity to stressed markets could accelerate downward price pressure at exactly the wrong time, thereby increasing risk to the system.

The Risk of Failed Transactions is Extremely Low and Already Captured Within Relevant Accounting and Capital Standards

One of the concerns cited by the Committee for proposing Option A is that, once a commitment is made to buy or sell a security, exposure to loss increases based on the possibility that the bank's counterparty will not perform, resulting in a "failed" transaction that could in turn lead to a loss arising from a decline in value of the security at issue. There are a number of reasons why this concern is misplaced.

First, as described above in the context of DvP, the LR exposure measure under Option B already includes an exposure to cover fully the risk of loss from a decline in value of the purchased or sold security.

Second, under the operative accounting frameworks in jurisdictions permitting an offset for receivables and payables associated with unsettled trades, should a failed trade occur, the bank would no longer be permitted to offset any cash receivable or payable associated with that particular trade. Instead, the bank would be required to unwind on its books any offsetting of cash receivables associated with the trade, which has the effect of "grossing up" the bank's unsettled assets for the failed trade until the trade settles or the bank enters into a new trade.

Third, the proportion of securities transactions that result in "fails" is extremely low.[8] As a result, even if a "fail" did result in increased risk to the bank, the probability of such an event occurring is extremely low relative to total trading volume and certainly would not justify the substantial and grossly disproportionate

[8] Based on publicly available data on the risk-weighted assets ("RWAs") of six European trading banks, the RWAs relating to failed trades and settlement risk comprise a weighted average of 0.3% of the total RWAs of such banks' Corporate Banking and Securities business lines. The six banks are HSBC, Barclays, Deutsche Bank, Nodea, Société Générale, and Groupe BPCE.

increase in the leverage exposure measure that would result from the over-counting under Option A.

Finally, any concern about loss in market value of a security that the bank is forced to retain due to failed transactions is a risk-based concept, not a LR concept. Because of DvP, under Option B, the LR exposure measure would fully account for the value of a traded security or its associated cash, but would not and should not fluctuate based on the relative riskiness of the security or on potential operational losses that could be caused by failed transactions. Those kinds of risks are instead reflected in the risk-based rules, which include add-ons for failed trades.[9]

The LR Is Not Intended to Capture Market Risk

Apart from the risk of failed transactions, to the extent the Committee is more generally concerned about the bank's exposure to a change in the market value of securities purchased or securities sold prior to settlement, that is fundamentally a risk-based concern that relates to the relative riskiness of different types of assets, and not a LR concern where exposures never vary according to different asset types. For example, under DvP, where $100 in cash is exchanged for $100 in a particular security, the LR exposure should be no more than $100 during the period of trade date through settlement date because no additional exposure is created by the exchange of one asset for the other – and the LR exposure surely should not be $200 during this period. While some market risk may be assumed between trade date and settlement date, it is the type of risk that should be and is captured under the market risk rules.

Option A Would Put Bank-Affiliated Dealers at a Significant Disadvantage in Competing with Non-Bank-Affiliated Dealers

Option A would also confer a substantial competitive advantage on securities dealers that are not affiliated with banks, which by definition would not be subject to the LR and Option A's much higher capital charges for unsettled trades. In markets such as the United States where there are major broker-dealers unaffiliated with banks, and thus exempt from the LR, applicable broker-dealer net capital rules do not impose a comparable penalty for facilitating the settlement of normal course securities transactions where there is no settlement failure, even though broker-dealer net capital rules otherwise generally impose deductions for unsecured receivables.[10] Such a disparity would have the effect of pushing more client trading

[9] For instance, section _.38 of the U.S. banking agencies' capital regulations includes a RWA charge for unsettled trades pending for 5 or more days past the contractual settlement date. A bank also might reflect operational risk for failed trades.

[10] *See, e.g.*, 17 Code of Federal Regulations § 240.15c3-1 (United States broker-dealer capital rules).

activity out of prudentially regulated bank-affiliated broker-dealers without any improvement to system-wide risk management.

For all of these reasons, we strongly oppose Option A's approach of effectively adopting trade date accounting without permitting an offset of cash payables against cash receivables, and instead strongly support Option B – subject to the modifications we suggest below.

II. The Basel Committee Should Amend the Proposed Conditions of Option B

Under proposed Option B, in order to offset cash payables against cash receivables associated with financial asset purchases and sales, three conditions must be satisfied:

1. The bank serves as a market-maker for the financial assets;

2. The financial assets bought and sold that are associated with cash payables and receivables are fair valued through income and included in the bank's regulatory trading book as specified by paragraphs 8 to 20 of the market risk framework; and

3. The transactions of the financial assets are settled on a delivery-versus-payment (DvP) basis.

Only the third condition – DvP – bears a fundamental relationship to the risks the Committee has identified in the Proposal. In contrast, there are no identified conceptual reasons for the first two conditions, which would needlessly and substantially reduce the amount of set-off otherwise allowed under current market and accounting practices. Accordingly, for the reasons set forth below, we believe that the final LR standard should include only DvP as a condition for a bank to offset cash payables against cash receivables. That said, if the Committee should nevertheless decide to include the market-maker condition, we strongly believe that the text of that condition should be amended and clarified to conform to the explanation for that condition in the preamble to the Proposed Rule.

The Market-Maker Condition Is Unnecessary and Overly Restrictive

The Market-Maker Condition is Unnecessary

The Proposal offers no explanation for requiring an entity to be a market-maker in order to be eligible to offset cash receivables and cash payables for unsettled DvP trades, and we do not believe there is any reason to impose such a requirement for LR purposes. While the accounting standards of some jurisdictions allow entities using trade date accounting to offset receivables and payables only if they are

"broker-dealers," banks in those jurisdictions tend to concentrate their securities trading activities in broker-dealer subsidiaries.

In contrast, banks in other jurisdictions may conduct their securities trading activities through business lines or functions that cross multiple entities, or may apply multiple accounting frameworks to a single entity based on function or business line. For these banks, a condition that requires classification on an entity basis could require restructuring or create other significant complications that would make the proposed version of Option B unworkable in practice. In addition, banks in jurisdictions that allow for settlement date accounting do not have to satisfy a "market-maker"-type standard to use settlement date accounting. For banks in those jurisdictions that may not satisfy the proposed market-maker condition because of their low volume of trading, the condition would unfairly provide their trading bank competitors with an undue regulatory and competitive advantage. As a result, the condition could lead to a concentration of trading activities at banks that clearly satisfy the market-maker condition, thereby decreasing liquidity. The final standard should not create such competitive imbalances and barriers to liquidity by including the market-maker condition.

As Proposed, the Market-Maker Condition is Overly Restrictive

In any event, if the Committee should decide to include the market-maker condition, the condition should be clarified and amended to align with market practice. As drafted, Option B would require a bank to serve as a "market-maker for the financial assets" that are the subject of the transactions at the trade date, with the term "market-maker" defined as an entity that (i) provides intermediary services to clients and other market participants, ensuring market liquidity and supporting price discovery; and (ii) contributes to the robustness of market liquidity by absorbing temporary supply and demand imbalances, dampening the impact of shocks on market volatility, and quoting prices to support investors in valuing assets. We assume that the Committee intended for the term "market-maker" to accommodate any entity that is or functions similarly to a "broker-dealer" as that term is defined under the relevant accounting standards in jurisdictions that currently permit broker-dealers to offset cash payables against cash receivables for unsettled trades.

Nevertheless, the proposed condition presents two technical issues. First, the proposed text of Option B (as opposed to the description of the text in the preamble) would include as a condition that the bank is a market-maker "for the financial assets" that are the subject of the transactions at the trade date (emphasis added). This language could be read to allow the offset with respect to particular assets like securities only where the bank is making a market in those particular assets. This

result is inconsistent with the description of this condition in the preamble explanation, which does not include the phrase "for the financial assets" and instead provides that the condition would be satisfied for all of a bank's trading assets so long as the bank qualifies as a market-maker for any of its assets (which produces an outcome consistent with market practices in those jurisdictions that permit an offset for accounting purposes). There is no sound reason to restrict the eligibility for offset to only those transactions involving particular financial assets for which a bank is making a market. Therefore, Option B should be clarified so that a market-maker can offset cash payables against cash receivables associated with any type of financial asset.

Second, as noted above, the Proposal's reference to "entity" in the definition of market-maker would create significant uncertainty for global banking groups that conduct their securities trading activities through business lines or functions that cross multiple entities. We therefore recommend that the final standard replace the proposed definition's reference to "entity" with the phrase "entity or group."

The Trading Book Condition is Unnecessary and Would Create a Significant Compliance Burden

Trading book and non-trading book securities present the same exposure to a bank, and no reason was identified in the Proposal to exclude non-trading book securities from the offsetting under Option B. Moreover, this condition would be difficult and costly to implement in practice for organizations where receivables and payables for trading book and non-trading book securities generally are posted to the same general debtor or credit nominal account. In addition, disentangling a bank's available for sale trades from other trades eligible for offsetting would be extraordinarily complex as an operational matter. Finally, there is uncertainty as to how the relatively new definition of the term "trading book," which the Committee adopted in January 2016 as part of the Fundamental Review of the Trading Book, will be implemented in different jurisdictions, and whether the definitions implemented in member jurisdictions will be appropriate in the context of the LR. For these reasons, we believe the final LR standard should not include the condition that the financial assets bought and sold that are associated with cash payables and receivables are fair valued through income and included in the bank's regulatory trading book.

The Basel Committee Should Simplify Option B For Banks Using Settlement Date Accounting

As proposed, Option B appears to require a settlement date accounting bank to increase its LR exposure by treating unsettled financial asset purchases as off-balance sheet items subject to a 100 percent CCF, while then permitting the bank to

offset that increase in whole or in part to achieve the "equivalent effect" of the offset that Option B permits for banks that use trade date accounting.

It would be extremely burdensome for a settlement date bank to build the systems necessary to calculate the offset as if it were a trade date accounting bank in addition to the systems it uses for settlement accounting – and fundamentally unnecessary since the calculation of the LR exposure using existing settlement date accounting would nearly always produce a similar result as that proposed in Option B.

Therefore, we suggest that settlement date banks qualifying to use Option B be allowed to continue to follow the accounting treatment of such trades for LR purposes should the Committee adopt Option B. We propose the following changes to the text regarding Option B:

"Option B

- *For such exposures, banks using trade date accounting must reverse out any offsetting between cash receivables for unsettled sales and cash payables for unsettled purchases of financial assets that may be recognised under the applicable accounting framework, but may offset between those cash receivables and cash payables (regardless of whether such offsetting is recognised under the applicable accounting framework) if the following conditions are met:*
    - *the bank is serving as a market-maker*. ~~for the financial assets~~;*
    - *the financial assets bought and sold that are associated with cash payables and receivables are fair valued. ~~through income and included in the bank's regulatory trading book as specified by paragraphs 8 to 20 of the market risk framework~~;*
    - *the transactions of the financial assets are settled on a delivery-versus-payment (DVP) basis.]*
- *Banks using settlement date accounting will be subject to the treatment set out in paragraphs 43 to 45 and paragraph 9 of the Annex."*

** For the purposes of this treatment, a market-maker is an entity **or group** that (i) provides intermediary services to clients and other market participants, ensuring market liquidity and supporting price discovery; and (ii) contributes to the robustness of market liquidity by absorbing temporary supply and demand imbalances, dampening the impact of shocks on market volatility and quoting prices to support investors in valuing assets.*

* * *

"9. A 100% CCF will be applied to the following items: . . .

Option B

- *The exposure amount associated with unsettled financial asset purchases (ie the commitment to pay) where regular-way unsettled trades are accounted for at settlement date* ***unless*** *~~. Banks may offset commitments to pay for unsettled purchases and cash to be received for unsettled sales provided that~~ the following conditions are met: (i) the bank is serving as a market-maker* ~~for the financial assets~~; (ii) the financial assets bought and sold that are associated with cash payables and receivables are fair valued ~~through income and included in the bank's regulatory trading book as specified by paragraphs 8 to 20 of the market risk framework~~; and (iii) the transactions of the financial assets are settled on a DVP basis."*

3. Cash pooling

Notional cash pooling is a cash management solution offered by banks to their clients whereby the balances of multiple bank accounts are virtually combined to assist clients with daily liquidity management. Clients who typically use notional pool structures are large corporates who provide products and services to the real economy. The benefits of notional pooling are reduced liquidity management and operational burden to the treasury functions. Notional pooling has been embedded in the operations and liquidity management functions of these clients for decades. A reduction in service offering or substantially increased costs, due to changes in how the structures are treated in the LR, would result in clients having to fundamentally change how they operate and manage cash. In our view, this is an undesired outcome without a real underlying leverage issue that needs to be addressed. We lay out below the reasons why we believe that notional pools that achieve single unit of account treatment should be treated as such also for leverage purposes. This treatment is broadly consistent across accounting rules.

Single or multiple affiliated client legal entities open demand deposit accounts (DDAs) and the nominated DDAs are subject to a Pooling Agreement executed by the bank and all of the client entities. For accounting purposes, certain notional pooling arrangements are treated as a single unit of accounting, whereby a single amount is owed to or from the client entity (or the group of affiliated client entities) subject to the Pooling Agreement.

Such Pooling Agreements generally include the following:

- In notional pooling arrangements single or multiple affiliated client legal entities open DDA accounts. The nominated DDA accounts are then subject to a Pooling Agreement, signed by the bank and each client entity;
- A legal right for the bank, at any time, without notice, to apply funds held in one DDA to satisfy an overdraft in another DDA subject to the Pooling Agreement;
- Provisions specifying that each pool participant is jointly and severally liable to the bank in respect of the other pool participants' obligations to the bank, including costs, expenses and legal fees - or in relation to any account in the pool but limited to any amounts due from [the bank] to the relevant pool participant in respect of any credit balance on such pool participant's accounts in the pool. Some Pooling Agreements include cross guarantees across all client entities for any debit balances on any pooled account, in lieu of joint and several liability provisions; and
- Authorization of the bank to notionally combine the DDA accounts of any client entities to reflect one unit of account. The combining allows the client to potentially reduce overdraft costs and the bank to reduce the amount of interest paid to the client.

These provisions, together with legal opinions that support the enforceability of the bank's right to combine deposits and overdrafts, create a single unit of account for certain cash pooling arrangements.

From a leverage exposure point of view, failure to recognize a single unit of account structure results in the pooled accounts (overdrafts and deposits) being presented gross in total leverage, resulting in an overstatement of leverage exposure.

In our view, due to the underlying economic characteristics of the notional cash pooling agreements, splitting the single unit into debits and credits, thereby grossing up balances under the notional pooling arrangements, is inconsistent with the treatment under generally accepted accounting principles. Grossing-up these balances also creates complexity in the LR calculation and inconsistencies with both accounting and credit risk treatment. The impact would also increase the costs for the corporate borrower for a product that is an effective and efficient cash management solution.

The industry suggests adding the following to the text of the LR guidance:

"(a) On-balance sheet exposures:

[18.] Unless recognized as a single unit of account for accounting purposes, balances resulting from a notional (or virtual) cash pooling arrangement that combines several

accounts of the entities within a corporate group without physical transfer of funds must be reported on a gross basis in line with revisions to paragraph 13 (paragraph 11 as revised) of the Basel III leverage ratio framework, which does not allow netting of assets and liabilities nor the recognition of credit risk mitigation techniques."

4. Credit conversion factors (CCFs)

The industry recognizes the need for simplicity in the LR framework and that therefore the treatment of CCFs in the LR should in principle be aligned with changes into the SA in the credit risk framework. However, as noted in industry responses [11] to the second consultative document on revisions to the standardized approach for credit risk response, the proposed changes to CCFs are extremely significant and appear to be inconsistent with the stated goal of the BCBS to avoid significant increases in overall capital requirements. Furthermore and most importantly, the levels proposed under the new SA to credit risk are not reflective of industry data or experience[12].

CCFs apply to off balance sheet ("OBS") instruments that are key financing tools for consumers and businesses. Such products are a prevalent feature in lending spaces such as project, trade and commodities finance. They provide additional liquidity to meet customers' financing demands even for market based financing (such as facilities to support commercial paper programmes), help avoid pro-cyclical effects that can occur in liquidity stress conditions and represent an important portion of financial firms' banking books. The changes could negatively impact the clients that rely on the associated products by limiting their availability or accessibility through increased costs of payment and financing facilities for retail customers and for working capital funding for both SME and larger corporate firms.

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[11] http://www.gfma.org/Initiatives/Basel-III/GFMA,-IIF,-ISDA-and-IACPM-Comments-to-Basel-on-the-Second-Consultative-Document-on-Revisions-to-the-Standardized-Approach-for-Credit-Risk/

[12] https://www.theclearinghouse.org/issues/articles/2016/03/20160316-tch-comments-to-basel-committee-on-standardized-approach-to-credit-risk

See also GCD data referenced in the GFMA, IIF, ISDA and IACPM response to the RSA (previous footnote above). The data on page 33 of the response indicates that not only CCFs are more granularly different among products but also the proposed CCFs (for example, 50 – 75 % CCFs for commitments other than the retail UCC) are, in most cases, too conservative.

The Associations believe that the treatment of CCFs should be further considered within the SA credit risk framework prior to incorporation into the LR framework. Specifically, we recommend that any calibration of CCF's should be based on the industry data referenced earlier and take into consideration the factors influencing their behaviour, including if the facility is unconditionally cancellable (e.g., credit cards where data shows that the CCF is lower than 10%). Furthermore, we recommend that CCFs could be broken down according to the following risk drivers to determine the appropriate segmentation instead of a calibration based on a flat CCF applicable for all segments of retail or wholesale exposures:

- The type of commitment, e.g. cash commitments versus contingent facilities (transaction related contingencies);
- Whether the facility is unconditionally cancellable or not – contractual and legal environments make an economic difference which must be recognised;
- The type of obligor (e.g., Corporates or small firms) to which the facility is granted, bearing in mind that CCFs are applicable to products aimed at all types of customer bases;
- The type of facility including, term loans, revolving loans, and other lines of credit including guarantees and letters of credit for non-retail clients or personal lines of credit, credit cards and other revolving lines of credit such as HELOC's, for retail clients; and
- The residual maturity of the underlying facility may also impact on the level of CCF associated with a facility.

5. SA-CCR's Replacement Cost in the LR

The BCBS consultation proposes to reflect derivative exposures as an EAD, including both replacement cost (RC) and the potential future exposure (PFE), calculated based on a modified version of SA-CCR. With respect to RC, we appreciate that the modifications are intended to ensure general alignment with accounting where only cash variation margin is reflected. We believe, however, that the reflection of the on-balance sheet component of derivatives through a modified RC component as part of the SA-CCR EAD appears inconsistent with the underlying principle that the on-balance sheet assets, and not a risk-based measure, should be the basis for the LR. Therefore, we think that the calculation of the on-balance sheet exposure component should largely follow the process of other assets by directly referencing the balance sheet with certain modifications that ensure jurisdictional consistency. This would have the benefit of introducing further simplicity in the LR framework. This can be achieved by aligning the calculation of the on-balance sheet component

with the current methodology. This implies that the Alpha factor of 1.4 would not be applied to the RC. In addition, this also means that netting of derivatives within the RC would not follow risk-based considerations in relation to multiple credit support annexes (CSAs) and multiple netting sets as per paragraphs 185 till 187 but would be consistent with current rules aligned with accounting standards. We set out below our reasoning underlying our suggestion.

Consistent approach to on-balance sheet components with other exposure types

An alpha factor of 1.4 in the context of the LR would call into question the accuracy of derivative valuations. However, there is no inherent reason to believe that the valuation of derivative assets is less reliable than the valuation of other assets on the balance sheet. Derivative valuations are subject to stringent independent price verification controls and procedures. They are also subject to independent third party audit, just like all other asset and liability values on the balance sheet.

Consistent approach to the on-balance sheet component of cash variation margin

We understand that netting of derivative assets against cash variation margin received or derivative liabilities against cash variation margin posted is only allowed under certain conditions in accordance with underlying accounting principles. Since this is an accounting driven determination, cash variation margin should be treated consistently outside the SA-CCR EAD calculation with general accounting standards and not as proposed as part of the EAD calculation if the criteria for cash variation margin netting are met and as part of the standard on-balance sheet asset calculation if the criteria are not met.

Application of alpha factor inconsistent with a non-risk balance sheet driven exposure amount

The industry understands that the alpha factor was initially introduced to produce loan-equivalent EAD for the purpose of calculating credit risk RWAs for derivative transactions. It was meant to take into account model risk, potentially high correlations of exposures across counterparties as well as the potential lack of granularity across counterparties (as the capital parameters are calibrated assuming an infinitely diversified portfolio). A reflection of these considerations would be inconsistent with the basic underlying principle of determining exposures in the LR based on the actual on-balance sheet exposure amounts unadjusted for risk.

Furthermore, applying the 1.4x alpha factor to RC will particularly penalize derivatives transacted with uncollateralized counterparties, mainly corporates and sovereigns, given that positive present value (PV) will be particularly significant in these cases as it cannot be offset with any collateral. This is particularly magnified by the directional nature of exposures of certain end-users, e.g. exposure on a pension fund portfolio. Finally, the alpha factor will also amplify the effect of market volatility in PV (e.g. move of interest rates) in the LR exposure (LRE), despite LR meant to be non-risk-based. This will create more difficulties for banks to manage the volatility of LRE, especially at times of significant market stress.

6. Recognition of Initial margin (IM) for cleared and uncleared derivatives

The industry welcomes the decision by the BCBS to collect data to study the impact of the LR on client clearing, with a view to potentially recognizing the exposure-reducing effect of IM. The industry thinks that, in the context of a bank exposure created by a cleared derivative transaction, the LR framework should recognize the exposure-reducing effect of IM, particularly as it is not used to increase the bank's leverage. Treating IM for client clearing as additional LRE, as under the current LR framework, unnecessarily and significantly overstates LRE, acting against client clearing businesses, and contradicting the G20 mandate by creating an economic disincentive for clearing brokers to offer clearing services. Preliminary results from our industry LR Quantitative Impact Study (QIS), based on aggregated results from 21 international banks, show that ignoring the exposure-reducing effect of IM for client clearing results in a 79 % increase in client cleared transactions LRE compared to recognizing the exposure-reducing effect of IM.

The industry, however, regrets that the BCBS has not taken the opportunity to consult on the recognition of IM outside the case of client cleared transactions, typically in the case of uncleared bilateral trades. Under the current BCBS rules on non-centrally cleared derivatives, the mandatory IM requirements have the effect of grossing up the balance sheet and increasing LRE through either the cash IM posted to the counterparty (which will be a receivable) or through the additional securities inventory that must be held to meet requirements. Meanwhile, there will be no derivative exposure mitigation from the IM received under the proposed framework, as the PFE multiplier is being set to 1 for any amount of IM exchanged. We believe that this is inconsistent with the objectives of the margin requirements for non-centrally cleared OTC derivatives which include establishing "a robust regulatory framework by improving prudential regulation so that non-centrally

cleared derivatives are bilaterally collateralised and subject to either margin or capital requirements". Preliminary results from our industry LR QIS show that ignoring the exposure-reducing effect of IM for uncleared bilateral derivatives currently results in a 9 % increase in bilateral OTC derivatives LRE compared to recognizing the exposure-reducing effect of IM. As indicated by the significant offset associated with the recognition of IM for client cleared exposures, it is expected that the impact of not recognising IM offset for non-cleared OTC derivatives is likely to become much more pronounced as the implementation of margin requirements progresses.

The lack of a specific treatment to address IM requirements artificially overstates leverage on a system wide basis because only one party can ever be in-the-money on a derivatives contract and since non-centrally cleared OTC derivatives rules require two-way margin there will always be a surplus of IM relative to default risk. Furthermore, due to the segregation requirements, banks cannot use IM received to leverage themselves. We therefore think that the BCBS should give further consideration to the coherence between non-centrally cleared OTC derivatives rules and the LR framework, particularly regarding the exposure reducing effect of IM.

Furthermore, even recognition of any exposure-reducing benefit of IM through the PFE multiplier, as currently formulated in SA-CCR, will only result in reduction that is not in line with the level of risk mitigation provided by IM. In the formulation, the PFE will not fall accordingly as it is dependent on the exponential multiplier which is significantly more conservative than the model-based multiplier (BCBS WP26). We understand the choice of the exponential multiplier is based on MTM value of real netting sets being likely to exhibit heavier tail behavior than the one of the normal distribution. While fatter tails than those implied by a normal distribution do exist, the conservative calibration of the $AddOn^{aggregate}$ calculation already compensates this. This means that the introduction of the exponential multiplier constitutes a double count of fat tails. This is even more problematic as the 5% floor and the application of collateral haircuts to the collateral values (please see below's comment) introduce additional factors in reducing the risk mitigating benefits of overcollateralization. This undermines the stated regulatory efforts to increase the level of collateralization of exposures as a means to decrease counterparty credit risk. This has become even more important for the industry given the margin requirements for uncleared derivatives and the associated considerable funding costs. The same calibration issue also applies when derivative transactions are not in a netting set, where the non-netting set transactions will receive relatively high add-ons but the multiplier will provide little relief. As such, even transactions with

significantly negative MTM will have large add-ons even when there is little chance of them to go in-the-money.

The industry also notes that negative MTM is currently reflected through the net-to-gross ratio (NGR) in CEM, and therefore finds it difficult to justify that negative MTM for unmargined transactions is not recognized in the calculation of PFE in the revised LR framework. We believe that negative MTM should be reflected in the calculation of the PFE add-on for derivatives transactions.

Finally, under SA-CCR, the collateral haircut approach is used to reflect the volatility of collateral where market price volatility and foreign exchange haircuts are applied to incoming and outgoing collateral as appropriate. Generally, such a simplistic approach seems problematic as on the one hand it models the volatility of collateral in isolation of other collateral or the overall trade population and does not recognize any diversification benefits while on the other hand it fails to reflect the uniqueness of certain types of collateral.

7. Recognition of high quality government bond securities to offset replacement cost in OTC derivatives exposure calculation

The inability to offset the replacement cost in the calculation of exposures associated with OTC derivatives with high quality liquid assets (HQLAs) received as variation margin (VM) incentivises banks to receive cash VM. This will likely have a disproportionate negative impact on certain types of end-users – such as pension funds and insurers – because many typically rely on the ability to post high quality securities as collateral. Such end users use derivatives to manage their financial solvency and, as a result of such treatment, could abandon the use of derivatives as hedging instruments or be forced to post cash VM resulting in significant cost and liquidity risk.

For example, European pension funds are typically fully invested and minimise their allocation to cash to generate long term returns that better match their liabilities. This has already been recognised by European policymakers in the context of the European Markets Infrastructure Regulation (EMIR), where European pension funds have been exempted[13], under Article 89(1), from clearing OTC derivative contracts

[13] Temporarily until August 16, 2017. The exemption may be extended again to August 16, 2018 - http://ec.europa.eu/finance/financial-markets/docs/derivatives/20150605-delegated-act_en.pdf

that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements. This temporary exemption was granted to ensure that European pension funds were not forced to post cash VM as required by clearing houses for cleared trades, but instead be allowed to carry on using OTC derivatives using the non-cleared markets while posting high quality securities as VM. The temporary exemption has already been extended once as no solution has been found for European pension funds to use high quality securities for posting VM for cleared trades as was hoped during the initial transitional period. Given the lack of any robust solution being found for this issue that could be relied upon in stressed market conditions, this temporary exemption could be extended again to 2018.

Without changes to the LR, punitively treating such derivative exposures collateralised with HQLAs is likely to have the effect of forcing pension funds, and other types of counterparties that rely on the ability to post securities as collateral, to instead post cash as VM. It also conflicts with the policy objectives that allow European pension funds to benefit from a clearing exemption.

Europe Economics and Bourse Consult, independent consultants commissioned by the European Commission estimated that an extra €205 billion to €420 billion of cash collateral would be needed if European pension funds were required to post cash VM, and cost European pensioners €2.3 billion to €4.7 billion annually.[14]

The effect will be compounded for these same end users as the BCBS Net Stable Funding Ratio (NSFR) limits variation margin received to cash that meets the LR netting standards and prohibits a bank from reducing its derivative assets with non-cash HQLA variation margin received from a counterparty, even when the securities received have cash-like liquidity characteristics (e.g., German Bunds or UK Gilts). This means that Bunds or Gilts, which are treated as cash equivalents for liquidity ratio purposes, are treated as if they were illiquid assets with no funding value.

Moreover, under stressed market conditions – where HQLAs are not permitted to offset derivative exposures – this could potentially lead to a significant increase in

[14] Page 10. *Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult* can be found here: http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf

While this report focuses on the potential impact of central clearing on pension funds, we would expect the impact to be similar where pension funds are forced to post VM in cash for non-cleared trades as a result of leverage ratio and NSFR rules.

demand for cash associated with large VM calls. This is likely to significantly increase liquidity risk and exacerbate downward pressure on falling asset prices as market participants sell out of physical assets in order to meet cash VM calls. This could therefore increase pro-cyclicality risk and reduce financial stability.

While we recognise that the BCBS chose to allow the recognition of cash variation margin (subject to certain conditions) as it could be viewed as a form of pre-settlement payment, and that there are potential accounting issues associated with received non-cash VM, given the potential impacts the lack of recognition of HQLA VM on end users, we believe the issue requires further consideration by the BCBS. We will continue to consider the issue and commit to maintaining a dialogue and providing commentary and analysis on possible alternative treatments with the BCBS over the coming months. We believe that it is crucial that the BCBS takes into consideration potential impacts on end users before finalising the framework in order to mitigate the risk that different jurisdictions transpose the LR differently. Divergent implementation would undermine the objectives of a globally consistent and coherent capital framework.

8. Securitizations

A well-calibrated LR which recognizes the benefits of securitization for originating banks can be both prudent and help meet global and regional policy objectives of reviving the securitization market in order to support growth and the real economy. The Committee itself, working with IOSCO, has undertaken considerable work in this regard. In Europe, where securitization markets have especially struggled to recover since the financial crisis, the European Commission has proposed a regulation as part of its Capital Markets Union initiative specifically to revive securitizations. A well-calibrated LR could create positive yet prudent incentives to support these important initiatives.

Introduction

The Proposal seeks to incorporate the Basel III (that is, the December 11, 2014 "Basel III Document, Revisions to the Securitization Framework", as amended) revisions to the Securitization Framework into the LR where relevant, including with regard to the Credit Conversion Factors (CCFs) for off-balance sheet items.[15]

[15] BCBS, Basel III Document: Revisions to the Securitization Framework (December 2014) (**"BCBS 303"**), available at http://www.bis.org/bcbs/publ/d303.pdf; BCBS, Consultative Document: Revisions to the Standarised Approach for Credit Risk (December 2015) (**"BCBS 347")**, available at http://www.bis.org/bcbs/publ/d347.pdf.

The Committee defines the Basel III LR as the capital measure divided by the exposure measure, with the ratio expressed as a percentage.[16] Both the capital measure and the exposure measure are calculated on a quarter-end basis.

The LR is not a risk-sensitive prudential measure: it seeks to constrain the accumulation of assets on the balance sheet regardless of the risk of those assets.

Traditional securitization, prudently deployed and sensibly regulated, delivers a number of well-known and widely acknowledged benefits which can help improve financial stability: broadly, these include the provision of incremental funding for the real economy and capital management for bank originators, specifically through both the sale of assets to third party investors without recourse to the seller, and (subject to applicable operational requirements) risk transfer to free up regulatory capital ("SRT").

Treatment under the LR where there is true sale without recourse to a special purpose vehicle (SPV) which funds the purchase by issuing asset-backed securities to unaffiliated third party investors. Accounting de-recognition is not achieved. SRT may or may not be achieved.

We propose that where a bank securitizes assets in a traditional securitization by placing tranches of that securitization with unaffiliated third party investors, without recourse to or where there is no repurchase obligation by the bank, the bank should be permitted to not consolidate the SPV in the regulatory consolidation perimeter, and for the purpose of calculating its LR it would include only those tranches which it retains[17].

We believe this treatment is justified:

- Even if the criteria for accounting de-recognition of securitized assets are not met, or even if the bank must include the related SPV for accounting purposes within the bank's consolidated group; and

- Whether or not the requirements for SRT are met.

[16] BCBS 365, page 5.

[17] Subject to any voluntary repurchase by the bank actually taking place, either due to the exercise of any contractually permitted call option or for any other reason, in which case the tranche should be re-included in the regulatory consolidation perimeter for the purpose of the Leverage Ratio.

For example, suppose a bank securitizes an asset pool of $100 nominal financed by $80 AAA/Aaa senior tranche and a $20 unrated junior tranche. There is no recourse to the bank (the "seller"). The senior tranche is placed with unaffiliated third party investors. The junior tranche is retained by the selling bank. We believe only the amount of this junior tranche should be included in the leverage calculation, because it is in effect the maximum amount of loss that the bank can sustain. This is achieved by placing the securitization SPV outside the scope of regulatory consolidation.

Using the same example, but assume now that the bank retains the senior tranche and sells the junior tranche. Here it is the senior tranche that will be included in the leverage calculation.

The LR should recognize that a bank's true economic exposure is reduced by the unaffiliated third party funding that is raised on a non-recourse basis.

We believe that treatment under SRT should be undertaken as a separate disconnected analysis. It is likely in the (simplified) examples above that SRT would not be achieved in the first example but could (subject to all the other relevant criteria being met) in the second example.

Further, regarding accounting treatment, while we acknowledge that there may be merit in taking this into account for certain exposure types, we believe its application in the context of securitization should be considered with caution such that deviation from accounting standards is warranted.

This is because most securitizations remain consolidated on banks' balance sheets because of restrictive accounting rules that make deconsolidation of securitizations difficult and in many cases impossible. Specifically, this is because in nearly all securitizations banks or their consolidated affiliates retain servicing, residual income after payment of all financing costs and credit losses, and (potentially) a significant portion of the most subordinated tranches.

Treatment under the LR of fully funded or collateralized synthetic securitizations

We also argue that the LR should recognize synthetic transfers as effective for removing assets from the regulatory consolidation perimeter for the purpose of the LR, but only when:

- the transaction not only satisfies the operational requirements for SRT for synthetic securitizations, but also

- is fully funded without counterparty exposure, or where an unfunded guarantee or credit derivative obligation is either zero risk-weighted or fully collateralized by collateral that meets the operational requirements for funded synthetic securitization, eliminating the risk that a counterparty will not fund to meet its obligations .

BCBS 303 pages 11-12 set out a comprehensive set of operational requirements for securitization to demonstrate how thoroughly securitization ensures the transfer of risk. We believe that these additional safeguards add sufficient protection to satisfy any concerns that reduction of risk will be illusory in the case of synthetic transactions.

Indeed, the Committee has stated that:

> The process of securitization from the originator's perspective can be viewed as similar to credit risk mitigation, as at least some risk of the underlying exposures is transferred to another party. Under this view, it would be inappropriate for a bank to have to hold more capital after securitization than before, as its risk should be reduced through the process of securitization. Supporting this concept is the operational requirement that significant risk be transferred in order to recognize any benefits from a securitization for originators and sponsors.[18]

We propose a change to the CCFs for off-balance sheet positions for securitizations undertaken by certain banks.

We propose that CCFs for off-balance sheet securitization positions should follow not the new proposed 100% CCF, but instead the existing CCF of 50% contained in the Annex in former paragraph 22, as set on page 26 of the Proposal.

We believe that 50% is an adequately conservative number for use in the LR to reflect conservatively banks' exposures, even in times of stress.

The Association for Financial Markets in Europe has undertaken research with a group of its internationally active large bank members after the credit crisis. This research has previously been shared with the Committee, in the context of other workstreams. This research shows that multi-seller ABCP Conduits drew on unused

[18] BCBS, Consultative Document: Revisions to the Basel Securitization Framework (December 2012) , page 32, available at http://www.bis.org/publ/bcbs236.pdf.

commitments even during such times of financial stress on average considerably below 50% of the unused commitments; in the case of the AFME research never more than 5.45% of the utilized portion of total commitments.[19]

A well-calibrated LR which recognizes the benefits of securitization for originating banks can be both prudent and help meet global and regional policy objectives of reviving the securitization market in order to support growth and the real economy.

Following the financial crisis, prudential regulation of capital, liquidity, market structure, transparency and disclosure have all been substantially enhanced. Against that more stable platform most policymakers now accept that securitization, prudently deployed and sensibly regulated, should be encouraged to finance the real economy. If banks become constrained by a measure of capital adequacy that does not take realistic account of actual risk transfer and commensurate exposure reduction, the constraint will artificially affect the way that banks allocate capital to business lines. The result will be uneconomic adjustments to pricing and availability of products that are important to the functioning of the so-called real economy.

In particular in Europe, where securitization markets have not recovered for many years since the financial crisis, the European Commission has proposed a regulation which seeks to revive the market for "simple, transparent and standardized" securitization[20]. The European Commission sees securitization as "an important channel for diversifying funding resources and enabling a broader distribution of risk by allowing banks to transfer the risk of some exposures to other banks, or long-term investors…. This allows banks to 'free' the part of their capital that was set aside to cover for the risk in the sold exposures, thereby allowing banks to generate new lending." Also, securitization can "lead to more credit for businesses and households" and also "provide additional investment opportunities."[21] European policymakers have recognized banks' struggles to extend credit due to the series of strict regulations adopted in the aftermath of the financial crisis.

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[19] AFME Data Submission to European Commission: historic liquidity funding for multi-seller ABCP conduits, 12th December 2012. See Annex 1.

[20] For example, for the European Union, please see European Commission, Proposal for a Regulation of the European Parliament and of the Council Laying Down Common Rules on Securitization and Creating a European Framework for Simple and Transparent Securitization (30 September 2015), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015SC0185&from=EN.

[21] European Commission, Press Release, A European Framework for Simple and Transparent Securitization, (30 September 2015), available at http://europa.eu/rapid/press-release_MEMO-15-5733_en.htm.

Interactions between multiple restrictions on liquidity and securitization may harm the real economy

The Committee should consider the combined effects of multiple restrictions on liquidity and securitization. The Committee has imposed further restrictions by developing two minimum standards for funding and liquidity: the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). With the objective of promoting short-term resilience of a bank's liquidity risk profile, the LCR requires a bank to maintain an adequate stock of unencumbered high quality liquid assets (HQLA) to meet its liquidity needs for a stressed 30-day period.[22] Additionally, the NSFR requires a bank to maintain an amount of available stable funding at least equal to the amount of its required stable funding.[23] However, these requirements have been designed such that no credit is given for the liquidity value of asset-backed securities (ABS) and not much credit is given for mortgage-backed securities (MBS).[24]

The Committee also has pending several other proposals that could place further limits on securitization. For example, the Committee has proposed that banks be barred from using internal models to calculate risk for wholesale exposures such as banks and large corporates[25]. This may well have a material impact on securitization exposures under the SEC-IRB approach for instance through the application of higher risk weights to the individual positions that are used to calculate the capital of the underlying securitization pool (KIRB). We also expect a reduction of the scope of the SEC-IRB approach. Currently, a bank must calculate KIRB for at least 95% of the underlying risk-weighted exposure amounts but may not be able to do so if the underlying exposures are no longer eligible for IRB, as will be the case for

[22] BCBS, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013), available at http://www.bis.org/publ/bcbs238.pdf.

[23] BCBS, Basel III: The Net Stable Funding Ratio (January 2014), available at http://www.bis.org/bcbs/publ/d295.pdf.

[24] The LCR is expressed as the value of HQLA divided by the total net cash outflows over next 30 calendar days. HQLA are comprised of Level 1 and Level 2 assets. Level 1 assets generally include cash, central bank reserves, and certain marketable securities backed by sovereigns and central banks. Level 2 assets are comprised of Level 2A and Level 2B assets. Level 2A assets include certain government securities, covered bonds and corporate debt securities. Level 2B assets include lower rated corporate bonds, residential mortgage backed securities (RMBS) and equities that meet certain conditions. ABS or other forms of MBS are not included. Level 2B assets may not account for more than 15% of a bank's total stock of HQLA. Similarly, the NSFR gives credit to only RMBS with a credit rating of at least AA.

[25]BCBS, Consultative Document: Reducing Variation in Credit Risk-weighted Assets – Constraints on the Use of Internal model Approaches (March 2016), available at http://www.bis.org/bcbs/publ/d362.pdf.

wholesale and specialized lending exposures[26,27] Additionally, the Committee has undertaken a process to identify and address step-in risk – the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations due to reputational risk.[28]

Failure to recognize for LR purposes securitizations that achieve either true sale, or true sale and true risk transfer that results in reduction of a bank's exposure, would significantly exacerbate the already unfavorable regulatory environment for securitizations and likely further reduce market liquidity for ABS and MBS and the amount of primary issuances. Issuers will not be able to charge economically rational prices for ABS and MBS, and underwriters will be discouraged from creating secondary market liquidity for primary issuances, thus further discouraging primary issuance. Consequently, the real economy will suffer.

Conclusion

A well-calibrated LR which recognizes the benefits of securitization for originating banks can be both prudent and help meet global and regional policy objectives of reviving the securitization market in order to support growth and the real economy. The Committee itself, working with IOSCO, has undertaken considerable work in this regard. In Europe, where securitization markets have especially struggled to recover since the financial crisis, the European Commission has proposed a regulation as part of its Capital Markets Union initiative specifically to revive securitizations. A well-calibrated LR could create positive yet prudent incentives to support these important initiatives.

We appreciate that our proposal may require further discussion with the Committee. We would be pleased to do so at the Committee's convenience.

9. Secured Financing Transactions (SFTs)

While the consultation paper seeks feedback only on treatment of open-ended repos, we highlight an additional issue relating to SFTs in this section that is inconsistent with the objectives of the LR and result in double counting of exposures.

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[26] Please refer to the GFMA/ISDA/IACPM/JFMC response to the proposed revisions to IRB for further information.

[27] BCBS, Consultative Document: Reducing Variation in Credit Risk-weighted Assets – Constraints on the Use of Internal model Approaches (March 2016), available at http://www.bis.org/bcbs/publ/d362.pdf.

[28] BCBS, Consultative Document: Identification and Measurement of Step-in Risk (December 2015), available at http://www.bis.org/bcbs/publ/d349.pdf.

Open-ended repos

Open-ended repos present standard market practice in certain countries, where this practise has been developed in order to reduce operational burden between counterparties that often rollover their overnight transactions if funding requirements do not change materially. In these cases, the transactions can be unwound unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day. We believe that these transactions should be treated as if they had a one-day maturity and that the requirement that they have the "same explicit final settlement date" should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The BCBS leverage framework otherwise results in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos).

We believe that treating open-ended repos as overnight repos is appropriate when the following characteristics are met:

- Open repo is used to invest cash or finance assets where the parties are not sure how long they will need to do so. Until an open repo is terminated, it automatically rolls over each day. An open repo can have a fixed or a variable rate. Interest accrues daily but is not compounded (i.e. interest is not earned each day on interest accrued over previous days). Outstanding interest is typically paid off monthly. The repo rate on an open transaction will be close to the overnight repo rate, but it will not change until the parties agree to re-set the rate.

- Collateral is marked to market daily in order to maintain the level of the haircut and a change in the market value of the securities portfolio triggers variation margins (with an appropriate and predefined threshold). Generally only very small portions of securities are moved every day (depending on the change in the mark to market value of the existing securities portfolio and possible change in the nature of the securities).

SFT double counting

The existing BCBS LR framework has a double counting anomaly for SFT exposures, which is not remediated in the consultation paper: For SFT transactions for which an on-balance sheet receivable is recognized (for example reverse repo and security borrowing transactions) and that are under-collateralized from the bank's perspective (i.e. the fair value of the collateral received is less than the cash provided), an SFT CCR exposure is added to the on-

balance sheet receivable. This creates an anomaly in terms of the LR exposure compared to real economic leverage as uncollateralized loans have a smaller exposure than under-collateralized reverse repos. While this issue is not directly consulted upon, we highly recommend that the BCBS takes this opportunity to amend the rules so that such double counts can be removed from the exposure measure.

10. PFE calculation for cleared transactions (CCP facing legs)

The BCBS consultation proposes that derivative exposures be calculated in accordance with SA-CCR. SA-CCR sets the Margin Period of Risk ("MPoR") for margined transactions to a minimum of 10 business days for non-centrally cleared transactions. SA-CCR allows a lower MPoR of 5 days **only** for centrally cleared transactions that are subject to daily margin agreements that clearing members perform as an agent for their clients. However, the current proposal does not specify the MPoR for the cleared transaction that the clearing member engages in from its own account.

As proposed, it appears that clearing members would have to use a 10 day MPoR for cleared transactions, the same as for non-cleared transactions. We believe this is inconsistent with the treatment for cleared transactions that a clearing member performs as an agent for their clients. The closeout risk of a cleared transaction that is on behalf of a client is no different from a cleared transaction out of a clearing member's own account.

While this dichotomy also exists in the risk-based capital framework, it is mitigated by the lower risk weights (2% or 4%), which is in part a recognition of the shorter close-out period involved in cleared transactions. The low risk weights do account for the shorter close out periods in the risk-based capital framework, however, because the LR framework is an exposure based measure, there is no recognition for the shorter close out periods. We therefore ask that the MPoR for cleared transactions for both client activity and clearing members' own transactions be set at a minimum of 5 days for the LR to ensure consistency and to recognize the shorter close out periods for all cleared transactions.

11. No haircut should be applied to cash variation margin (CVM) exchanged

A foreign exchange mismatch haircut is being introduced in the LR proposals to reduce the amount of cash VM that can be used to offset the derivative on-balance sheet MTM where the currency of cash variation margin does not match the termination currency of the netting set. We believe it is relevant to set out current business practice of termination currency and variation margin currencies:

- In the case of centrally cleared derivatives, CCP rules typically spell out a single "base" currency which would be used for determining a termination payment upon a CCP default. CCPs typically mandate the exchange of VM in the currency of the cleared transaction on a "gross" basis per currency silo, rather than net across currencies. This requirement is driven by CCP rules and regulations in certain jurisdictions (e.g., EU).

- In the case of Non-centrally cleared derivatives, standard ISDA agreements include "termination currency" as a defined term, which typically specifies a single currency as the termination currency. Currently, a typical netting agreement (if margined) generally is associated with one CSA and VM is typically exchanged on a net basis for the agreement. However, we highlight that Margin Requirements for Non-centrally Cleared Derivatives (MRNCCD), which is a regulation that has been promulgated by national supervisors around the globe, will introduce a new CSA construct that are expected to include two VM CSAs (prospective trades vs existing trades) and IM CSAs. Margin calls associated with each CSA will likely be settled on a gross basis per CSA, which may result in multiple currencies of VM payments.

Therefore, the existence of multiple VM currencies would appear to require that "FX mismatch" be determined on the VM currency level, rather than on a netting agreement level. We outline illustrative examples below for centrally cleared derivatives and bilateral (non-centrally cleared) derivatives, showing that the FX haircut as proposed is unworkable.

In the case of centrally cleared transactions, VM exchanges based on the underlying currency are not only a CCP rule requirement, but also mandated by regulation in certain jurisdictions (e.g. EU EMIR Article 38(b)[29]. LCH, a CCP that clears

[29] Article 38 Cash collateral: For the purposes of Article 46(1) of Regulation (EU) No 648/2012 [EMIR], highly liquid collateral in the form of cash shall be denominated in one of the following:

(a) a currency for which the CCP can demonstrate to the competent authorities that it is able to adequately manage the risk;

approximately two thirds of global OTC derivatives, requires VM to be exchanged in the currency of the cleared transaction on a "gross" basis per currency silo. The practice is driven by both the CCP rulebook and EMIR regulation. The same is true for Chicago Mercantile Exchange (CME), a US CCP that clears approximately one third of OTC derivatives. The reason for exchanging VM in the currency of the transaction is to eliminate the FX mismatch risk, we therefore believe that the proposed haircut is neither necessary nor warranted. The imposition of FX haircut to the gross MTM for a given currency can actually lead to significant haircuts that are unintended. For example, applying FX mismatch to the gross mark could lead to VM haircut being greater than the net MTM of a portfolio of cleared transactions in several cases.

Regarding non-centrally cleared derivative transactions subject to mandatory margin requirements, the industry and ISDA have been working on developing a new set of CSA constructs in response to the coming requirements. The new CSA construct is anticipated to include at least two VM CSAs, where each would spell out eligible VM currencies and the margin calls are expected to be issued or exchanged separately for the operational ease and monitoring purposes:

- Existing trades in a CSA that may include terms not necessarily new rules compliant (this CSA may also cover out of scope prospective trades)

- Prospective trades in a new CSA that is compliant with the margin rule

As a result, it is possible that there will be at least 2 currencies of VM exchanges within one netting agreement. VM collateral in multiple currencies under the CSAs will lead to FX haircuts applied to gross marks, similarly to cleared derivatives. This means that, here as well, applying FX mismatch to the gross mark could lead to VM haircut being greater than the net MTM of a portfolio of uncleared transactions.

In light of our above concerns on the likely unintended consequences of imposing FX haircuts to the gross MTM for a given currency, we believe that FX haircuts as proposed are unworkable. The risk-based capital framework already captures FX mismatches in practice, and implementing FX haircuts would introduce unnecessary complexity in the LR framework. Furthermore, the introduction of a risk-based haircut would be inconsistent with the basic premise that the on-balance sheet exposures should be aligned with accounting for the LR as stated above. We would

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(b) a currency in which the CCP clears transactions, in the limit of the collateral required to cover the CCP's exposures in that currency.

therefore propose that the concept of FX mismatch be removed from the LR framework. This would also help to ensure that the LR framework remains simple. Finally, preliminary results from our industry LR QIS show that applying an 8% haircut for FX mismatch on CVM results in a significant RC increase of 12 %.

If, however, the BCBS decided to retain a haircut in such cases, "termination currency" should be defined as the ISDA close-out currency (parenthetical reference to bankruptcy claim should be removed).

12. Reduction of the effective notional amount of a written credit derivative – condition on the strike of purchased options

The Basel Committee's proposed revisions include additional restrictions on the ability to use credit options by which the banking organization has the right to purchase credit protection as an eligible hedge. Notably, the strike price of the purchased protection must be less than or equal to the strike price of the written protection in order for a banking organization to achieve hedge recognition. Beyond these limited instances, credit options that have not been exercised cannot be recognized as "credit protection purchased through credit derivatives."

We are concerned that the deficiencies in the proposed approach will overstate the level of credit exposure that a banking organization has, thereby penalizing prudent risk management practices by disconnecting hedges from true underlying risk. In fact, we believe these restrictions could have the perverse impact of increasing systemic risk. We appreciate the concerns that indiscriminately recognizing purchased protection through credit options as hedges could result in residual risk that is not accounted for. However, addressing this concern through strike prices is inappropriate given the nature of credit options and how they are used.

Credit options predominantly reference credit indices; very rarely do they reference a single reference name. Therefore, market participants do not typically use credit options to hedge long-term banking book exposures or to gain long-term exposure to the credit markets. Rather, market participants use credit options to hedge short-term credit exposures or to gain short-term exposure to the credit market. The proposed restriction on strike price may be appropriate for long-term exposures and hedges in the banking book, however, it is inappropriate for the short-term market making positions that comprise banking organizations' "trading books," which are fundamentally different in their nature and risk profile.

Banking organizations act as market makers to facilitate client demand and therefore provide liquidity to the credit index market, rather than to take directional positions. Therefore, banking organizations' market making portfolios of credit indices and credit index options typically consist of a large number of client-driven positions and associated hedges. Little aggregate net risk exists because these positions offset each other, as measured by a variety of risk metrics. They are actively risk managed on an intraday basis and are subject to multiple risk limits. These aspects of credit options make them inappropriate for the restrictions around strike price. The proposal further does not allow offsetting the effective notional of a written CDS with the effective notional of an option where credit protection is purchased on the same underlying CDS; vice versa, it would not allow offsetting of the effective notional of an option where credit protection is sold with the effective notional of a purchased CDS. Limiting the scope of offsetting only to options is not justified. Economically, the exposure from an option where credit protection is sold may be offset by credit protection purchased through a CDS; equally, the exposure from protection sold through a CDS may be offset by an option where credit protection is purchased.

Furthermore, the proposed restrictions on strike price would be difficult to operationalise and implement because they are divorced from banking organisations' own risk management. Consider the following example:

- Trade 1: Bank A sells a 3-month $10Mn notional call option with a strike of 90 and a delta of 0.4. The bank therefore has a sold credit derivative gross-up of $10Mn
    - From a risk perspective, the bank's exposure is $4Mn ($10Mn notional * delta of 0.4)

- Trade 2: To hedge the economic risk, Bank A could buy a 3-month $5Mn notional call option with a strike of 70 and a delta of 0.8.
    - From a risk perspective, the bank's exposure is $4Mn ($5Mn notional * delta of 0.8)

While fully hedged from a risk perspective, Bank A has only hedged half of its sold credit derivative gross-up. Bank A would have to purchase double the size of the hedge they would normally do in order to fully offset the sold credit derivative gross-up of $10Mn. The proposed rule will therefore force banks to make the trade-off between prudent risk management and managing the LR Capital. This could have deleterious market impacts. Banks are able to provide liquidity and act as market makers across the range of strikes for credit options because they are able to

"connect" them through delta. If delta cannot be used, banks would need to cross clients strike by strike, which would result in a decrease in liquidity in credit options. Liquidity in credit options is important because they provide observability on tail risk and because they provide information on the distribution of an index. For example, an index with a 50% probability to finish at 90 and a 50% probability to finish at 110 will price the same way as the same index with a 50% probability to finish at 20 and a 50% probability to finish at 180. However, the credit options will price differently, which therefore allows clients and banks to better understand potential downside risks and hedge appropriately. The proposed change could therefore result in a less robust market and make banks more susceptible to tail risks.

To avoid market disruptions and to align the hedge recognition with prudent risk management, we believe it is more effective to use a delta-based exposure[30]. A delta-based exposure would be consistent with the Market Risk Rules and standard risk management practices. Delta is widely used as a measure of trading book exposures and hedge effectiveness. Each instrument's delta is a function of a variety of risk factors at a point in time, including maturity, volatility, and strike price. As such, deltas yield a more appropriate measure of exposure that is not limited to just strike price and would correspond with the way that banking organizations manage risk.

We recognize that the use of delta would incorporate a risk metric into the non-risk based LR. However, the Basel Committee has introduced a measure of risk through the strike price and we only ask that a more appropriate measure of risk be used. Furthermore, the Basel Committee has already integrated the use of deltas elsewhere into the Basel regulatory framework for measuring the potential exposure for derivatives transactions, with supervisory options volatility of 80%:

[30] Delta for non-tranched products will be between zero and one. An out-of-the-money stock option with a longer maturity would typically have a higher delta (closer to one than to zero) than would a shorter-dated option. This is because the likelihood that the stock price and strike price will align increases with time (among other factors). If a market maker were long $100 in a financial institution's stock, which has a delta of one, then the market maker would be more effectively hedged by buying a $100 notional position in a short option with a delta of one rather than by buying a short option with a delta of zero, such that the value of the short position would be as tied to the stock price as the long position in the stock itself. Yet, the Proposal would treat both short positions as either equally effective or ineffective offsets to the long position, depending only on the maturity date of the short positions.

δ_i	*Bought*	*Sold*
Call Options[13]	$+\Phi\left(\frac{\ln(P_i / K_i) + 0.5 * \sigma_i^2 * T_i}{\sigma_i * \sqrt{T_i}}\right)$	$-\Phi\left(\frac{\ln(P_i / K_i) + 0.5 * \sigma_i^2 * T_i}{\sigma_i * \sqrt{T_i}}\right)$
Put Options[7]	$-\Phi\left(-\frac{\ln(P_i / K_i) + 0.5 * \sigma_i^2 * T_i}{\sigma_i * \sqrt{T_i}}\right)$	$+\Phi\left(-\frac{\ln(P_i / K_i) + 0.5 * \sigma_i^2 * T_i}{\sigma_i * \sqrt{T_i}}\right)$
With the following parameters that banks must determine appropriately: P_i : Underlying price (spot, forward, average, etc) K_i : Strike price T_i : Latest contractual exercise date of the option		

We ask that deltas be applied consistently for all derivatives, rather than restricting their use to non-credit derivatives. While the use of deltas would normally add variability to the calculation because each individual bank will have their own unique approach to calculating deltas, using the supervisory and standard delta calculations would mitigate this concern entirely and would have the benefit of introducing further simplicity in the LR framework. The industry notes that the above is only one of the possible approaches to standard delta adjustments, we would be happy to work together with the BCBS to design a regulatory delta adjustment approach based on the Black and Scholes framework, satisfying the necessary requirements for the LR framework.

Alternative:

However, if a delta methodology was to be rejected, an alternative approach could be to consider the worst case scenario exposure where all names default with zero recovery, or equivalently all names trade at an infinite spread. It follows in this scenario that all options with the right to purchase credit protection would be exercised. The value of all options with the right to sell protection would reduce to zero. Since credit options are physically settled, the owner of the option always has the right to exercise their option regardless of its moneyness at option expiry thereby validating the assumption of all options being exercised, and showing how overly conservative the strike condition is in the Basel proposal.

Consider a portfolio of options where a bank owns an option to buy credit protection on an index at upfront strike of 10%. The option has a MTM of 1%. The bank has also sold another option where the bank has an obligation to sell credit protection on the same underlying index at an upfront strike of 5% which has an MTM of -2%. The default exposure of the portfolio under the alternative approach

would be 4% which should correspond to its written credit protection exposure as demonstrated below:

> Option exposure = MtM of all options + (1-upfront strike of sold puts/payers (options to buy protection)) – (1-upfront strike of bought puts/payers (options to buy protection)) = -0.02+0.01 + (1-0.05) – (1-0.1) = -0.01 + 0.95 – 0.9 = 0.04

Comparatively, under the current Basel III proposal the sold protection exposure of this portfolio would be 100% significantly overstating the maximum loss on the portfolio.

This methodology can be summarized by re-wording paragraph 32 as:
"32. *For the purposes of paragraph 31, the term "written credit derivative" refers to a broad range of credit derivatives through which a bank effectively provides credit protection and is not limited solely to credit default swaps and total return swaps. In particular, all credit options should be included in the "written credit derivative" calculation. All options which fulfill the conditions of paragraph 31, can be used to offset sold credit protection. The default exposure of an option that represents written credit protection should be its mark to market (MTM), plus, the notional amount of underlying credit protection multiplied by (1 – the upfront strike price %). Similarly, the notional offset amount of a credit option that represents purchased credit protection is calculated as the MtM + the notional amount of underlying credit protection multiplied by (1 – the upfront strike price %)"*

We believe that the delta approach offers a more suitable and complete solution as out of the money options would then have a lower delta thereby limiting their ability as hedging instruments. The delta approach should be extended to include options with the right to sell protection to better represent the true risk of the business. This follows naturally when one considers Put-Call Parity where the underlying asset can be created synthetically via combinations of put & call options.

13. "Connected or Correlated Counterparties" criterion should remain simple

The industry understands that the BCBS is concerned about banks recognizing purchased protection where there is a high degree of correlation between the underlying and the counterparty. The industry agrees that wrong way risk is an important concern that needs to be addressed within the Basel framework, however the linkage to the connected counterparty concept of the large exposure framework

will significantly increase the complexity of the leverage calculation, which runs counter to the stated aim of providing a simple non risk based fallback. The large exposure framework has a very different focus and purpose compared to the LR. Therefore, the industry believes that the connected test should be strictly limited to the identification of pairs of issuers and counterparties considered as affiliates for accounting purposes.

14. "Same Material terms" criterion is restrictive

As per paragraph 31, the revision to the LR introduces a new condition that requires that "the credit protection purchased through credit derivatives is otherwise subject to the same material terms as those in the corresponding written credit derivative." The industry is concerned about the potentially expansive interpretation of the meaning of "material terms". The industry believes that the conditions for offsetting have been specified in the other sections of paragraph 31 to ensure that the purchased credit derivative provides effective protection against the written credit derivative and, therefore, this new condition should be deleted from the final text. The industry believes that that it goes against the principle of a simple fallback measure, to introduce terms that can be very differently interpreted across jurisdictions and banks. If BCBS has specific concerns around conditions that have not been yet specified, the industry would be happy to engage with the regulators to discuss appropriate methodologies for those.

15. LR impact for inter-company clearing exposures should be assessed regionally

Par.29 of the revised Basel III LR framework states: "For the purposes of paragraphs 27 and 28, an entity affiliated to the bank acting as a CM may be considered a client if it is outside the relevant scope of regulatory consolidation at the level at which the Basel III LR is applied. In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation but the CM still has a trade exposure to the CCP. In this case, the transaction will be considered proprietary and the exemption in paragraph 27 will not apply."

This is particularly relevant for financial institutions that operate globally, and hence are regulated at the group level in the jurisdiction of the ultimate parent entity, as well as in other jurisdictions where their significant regulated subsidiaries are based. Typically, a subsidiary based in the region where the CCP is based would

be the clearing member (CM) of that CCP, and other entities within the group will clear through the CM subsidiary.

Both the affiliate and the CM subsidiaries would generally be included in the regulatory scope of consolidation at the group level. However, where CM is also a regulated entity in its own jurisdiction, the affiliated entity would often fall outside of the scope of the regulatory consolidation of the regulated sub-group in that jurisdiction.

For example, a Japanese bank that is regulated in Japan and is subject to JFSA regulatory requirements may have two subsidiaries, one based in Japan and another based in London. The London subsidiary is itself a regulated entity in the EU and subject to CRD IV and UK Regulatory requirements. The London subsidiary is also a CM of a U.K based CCP, and clears through the CCP on behalf of other Group entities, including the Japanese subsidiary. From the Group perspective both subsidiaries will be included in the accounting and regulatory consolidation, and trades between them will eliminate. Hence it may be concluded in the impact assessment that treatment of client clearing is not relevant for that Group and does not affect its capital position.

However, as the Japanese affiliate would be outside of the scope of regulatory consolidation in the EU, the trades cleared on behalf of the affiliate by the London-based CM will be subject to the provisions in par.27. As a result, the treatment of the client clearing business (including treatment of IM) will be relevant to determine the amount of capital the Group needs to provide to the subsidiary in order to maintain adequate capital and LR levels in accordance with regulatory requirements in that jurisdiction. This will have a significant impact for the Group and its ability to operate in the region as well as globally.

The industry believes the impact assessment on the client clearing business model should be performed at regional as well group level in order to adequately capture the impact of the proposal on the client clearing business model. This will ensure that the real economic impact of the proposed requirements is determined for financial institutions that operate globally and the assessment reflects the way clearing model is used internationally.

16. LR implications of the new lease standards

The new IFRS and US GAAP accounting standards for leases introduce a right-of-use model under which lessees will be required to account for a leased asset as a "right-of-use" (RoU) asset for all leases. This is a category of asset that does not have explicit treatment in the Basel capital and liquidity frameworks. Industry wishes to ensure that the ultimate categorization or treatment of ROU assets under the regulatory framework does not lead to inappropriate regulatory outcomes such as, for example, an appreciable increase in capital requirements for some firms. Industry considers that this would be anomalous given that it would be the result of a purely formal accounting change not corresponding to any economic change or change in the risk profiles of affected banks.

Inappropriate categorization would have obvious negative consequences for the LR calculations of banks. In particular, for those institutions who actively utilize lease financing in their business models (for premises or equipment), the impact could be material. And, although this submission is in response to the consultation on the LR, the issue has potentially broad implications for other elements of the regulatory framework including risk-based capital measures and liquidity requirements.

The industry wishes to highlight this potential issue in relation to the new standards and ROU assets and the Associations urge the Committee to engage with the industry in order to discuss the broad implications of the new lease standards in order to develop appropriate regulatory outcomes.

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Annex 1

afme/ Finance for Europe

Association for Financial Markets in Europe

Data submission to European Commission: historic liquidity funding for multi-seller ABCP Conduits

12th December 2012

Executive summary

- The strong liquidity performance of multi-seller asset-backed commercial paper conduits ("ABCP Conduits"), supported by the data in this document, warrants consideration for relief in the form of an adjusted calibration under Article 412 on:
  - undrawn liquidity supporting the ***utilised portion*** of total commitments funded by commercial paper (the "Utilised Portion"); and
  - undrawn liquidity supporting the ***unutilised portion*** of total commitments (the "Unutilised Portion").

- In this paper, we refer to the sum of the Utilised Portion and the Unutilised Portion as "Total Commitments".

- The currently proposed calibrations have the unwarranted consequence of severely penalising ABCP Conduits which:
  - have a 30 year operating history
  - have exhibited strong liquidity performance even during times of stress
  - fund the real economy: trade receivables, auto and consumer loans with good performance
  - are supported by sponsor banks, and
  - are relied upon by customers as a significant source of working capital.

- The data we present in this paper show that, historically, neither type of liquidity has been susceptible to "runs", even at the most stressful times through the crisis when, for example, liquidity supporting the Utilised Portion never funded more than 5.45% of the Utilised Portion of Total Commitments.

- In other words, through the crisis, ABCP Conduits continued to fund at least 94.55% of the Utilised Portion of their Total Commitments by issuing and selling commercial paper, as they were designed to do.

Executive summary (cont.)

- The Basel Committee's proposed calibrations for Higher Outflows under Basel 3 for liquidity lines provided to SSPEs were designed to penalise discredited structures such as Structured Investment Vehicles ("SIVs") and "arbitrage conduits", which experienced severe liquidity stress during the financial crisis.

- If the proposed calibrations are not adjusted to take into account the very different nature, and very strong – performance, of multi-seller ABCP Conduits, then they will:
  - reduce access to capital markets financing for customers, when financial conditions call for precisely the opposite policy objective
  - make remaining capital markets financing more expensive by forcing customers to pay twice: both on the yield demanded by the investor and on the cost of redundant liquidity required by sponsor banks to meet the Higher Outflow in the LCR framework
  - encourage these "real economy" assets to weigh on alternative bank financing sources at a time of significant de-leveraging pressure on banks

Section 1

KEY FEATURES OF ABCP CONDUITS

Funding of corporate receivables by ABCP Conduits is key for the real economy

- Multi-seller ABCP Conduits provide European corporates* with a sustainable and resilient funding alternative to borrowing directly from banks.

- At the end of 2011, the global market for multi-seller ABCP Conduits was just over €238 billion, of which a significant portion provided working capital funding to real economy assets in Europe.

- An incorrect calibration of the treatment under the LCR of liquidity lines to multi-seller ABCP Conduits will therefore have a material and adverse effect on funding of the real economy and cause these "real economy" assets to weigh on alternative bank financing sources at a time of significant de-leveraging pressure on banks.

* *Some large European corporate groups, for example Volkswagen, choose to originate receivables through subsidiaries that are regulated banks. The arguments we made in this paper for "corporates" apply with the same force to them even though technically they are banks.*

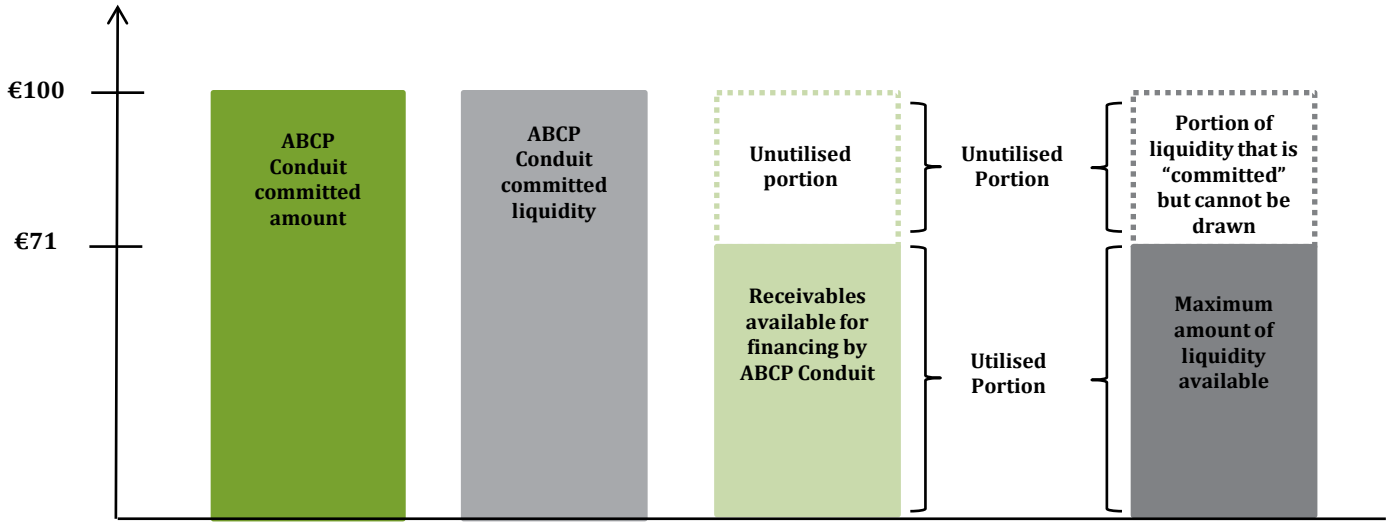
While both SIVs / arbitrage conduits and ABCP Conduits sought their funding primarily from the short-term commercial paper markets, the similarities end there

KEY DIFFERENCES BETWEEN SIVS / ARBITRAGE CONDUITS AND ABCP CONDUITS

SIVS AND ARBITRAGE CONDUITS	ABCP CONDUITS
Held long term financial assets, such as bonds	Fund short term trade receivables which are typically less than 90 days in tenor (with the vast majority shorter than 30 days), as well as other shorter term borrowing such as auto or consumer loans.
Funding need (and liquidity risk) at or close to maximum utilization as most SIVs were fully "ramped up"; they were highly dependent on financial market conditions	Funding need dependent on day-to-day financing needs of customers, namely whether business is good and a high volume of receivables is generated, or business is poor and a low volume of receivables is generated. Not systemic financial risk.
Proved to be illiquid under stress: short-term funding dried up, assets returned to banks' balance sheets or liquidity drawn, no market for sale of the underlying long term financial assets	Proved to be relatively liquid under stress: short term funding was less affected, some limited liquidity drawings, underlying assets were "real economy", short term and self-liquidating
Liquidity backup was dependent on financial market conditions: if there was no market for the assets, then liquidity was drawn	ABCP can be issued and liquidity put at risk of drawing only if good quality receivables are presented to the ABCP Conduit for funding. No receivables = No liquidity drawings or issuance of ABCP
Underlying assets performed poorly in credit and market terms: US sub-prime RMBS, US home equity loans, CDOs	Underlying assets were from the "real economy"; have performed and continue to perform well and within tolerances
Mis-used SSPE technology to exacerbate leverage and concentration of risk within the financial system	Well-established traditional use of SSPE technology to complement bank funding and share risk with capital markets investors
No longer active: no investor appetite and new regulations prevent re-emergence	Struggling to cope with new liquidity rules: some conduits have been closed because of the new liquidity rules

Key structural features of ABCP Conduits

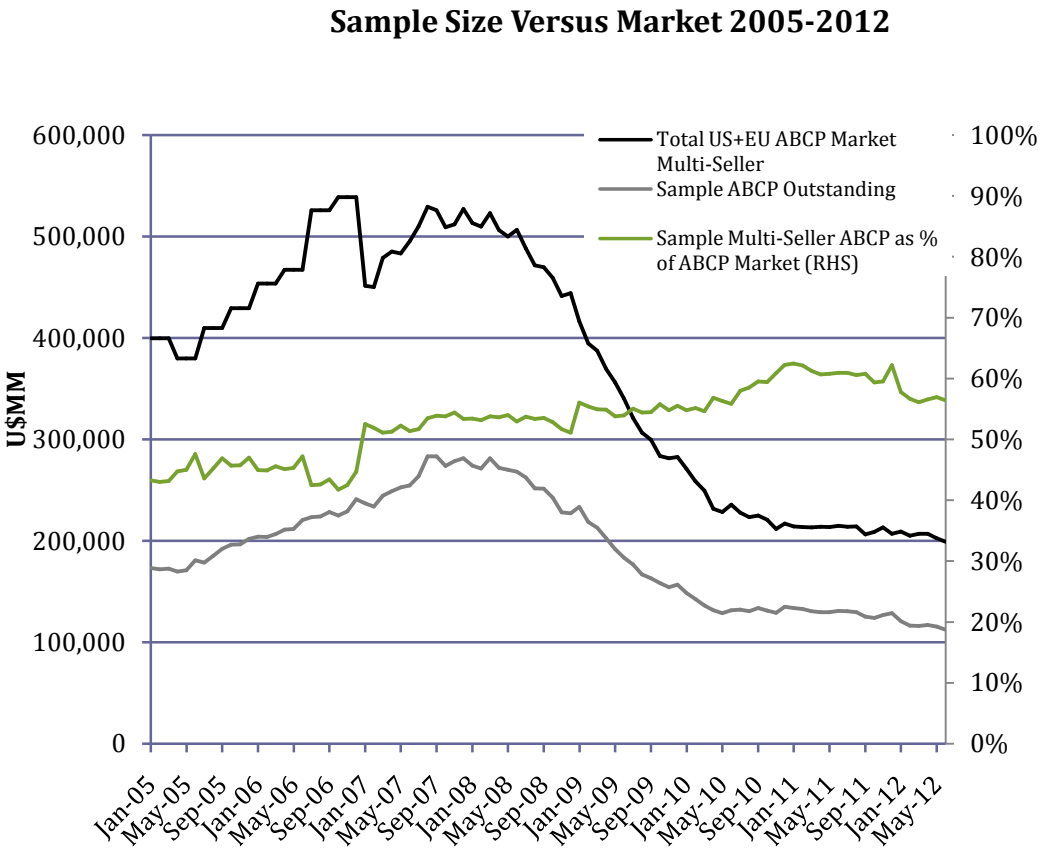
- ABCP Conduits are backed by liquidity provided by sponsor banks which are "committed"; however, the Total Commitments cannot be utilised, nor can liquidity be put at risk of drawing, unless specific conditions precedent are met.
- The first and most important condition – *which makes such liquidity very different from "ordinary" committed lines of credit provided to corporates* - is that sufficient receivables of good quality (there are "asset quality" tests) must be available for financing by the ABCP Conduit
- The amount of such receivables will depend on the needs of the day-to-day business of the corporate seeking funding from the conduit, for example:
  - whether business is good, and the corporate is selling high volumes of goods, or
  - whether business is poor, and the corporate is selling low volumes of goods
- Therefore, even if the "committed" amount of an ABCP Conduit and its supporting liquidity facility is €100, if only €71 of eligible good quality receivables are available for financing then no more than €71 of ABCP can be issued. The associated liquidity remains undrawn unless ABCP cannot be issued due, for example, to market disruption.



AFME has gathered data from 2005 to date, showing historic utilisation across the industry and through the crisis

Jan-05 to Jun-12

- AFME received data from 12 sponsor members representing issuance from over 27 multi-seller, multi-asset ABCP Conduits issuing in the Euro, Sterling and USD ABCP markets.
- Members submitted program commitment amounts, amounts of direct bank funding, ABCP outstanding, liquidity draw amounts, ABCP retained amounts, and the amount placed with government facilities on a month-end basis from January 2005 to June 2012.
- The time line was chosen to incorporate different stages of the economic cycle.
- Our sample represents an average of 55% of the global ABCP market for the period, and since 2009 over 60%.



Sources: Moody's, Member Data
Note: Pre-2007 market data is shown quarterly

Our approach to analysing the liquidity risk

- Assuming a given size of the Utilised Portion in an ABCP Conduit, the first aspect consists in evaluating how much funding pressure can be created for the sponsoring bank when the market is no longer able to provide the funding in the form of ABCP. Our data demonstrates that funding pressure is limited – see Section 2.

- The second aspect consists in evaluating by how much the Utilised Portion can increase, which – potentially – could add further funding pressure on to the sponsoring bank at times of stress (as per Section 2). Again, our data demonstrates that such growth remains controlled – see Section 3.

- Therefore we have kept both analyses separate and sequential. Firstly, we evaluate the liquidity funding given a certain Utilised Portion; secondly, we go on to analyse the evolution of that Utilised Portion.

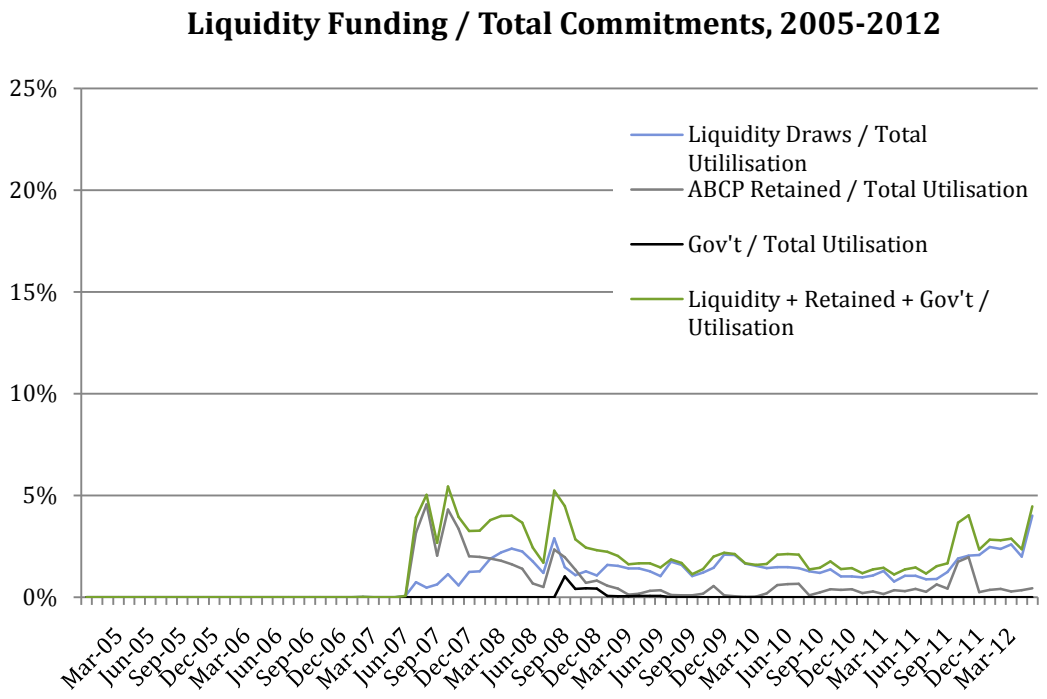
Section 2

Historic Liquidity Funding supporting the Utilised Portion of Total Commitments

Highest liquidity funding = 5.45%

Jan-05 to Jun-12

- We define "Liquidity Funding" to include (1) liquidity draws, (2) retaining ABCP on-balance sheet for non-investment purposes, and (3) accessing government funding relief programs.
- Liquidity Funding proved to be non-existent pre-July 2007.
- The majority of issuers experienced nil, or minor, Liquidity Funding in the post-2007 period.
- In total, Liquidity Funding peaked at c.$16bn, accounting for only 5.45% of total program funding requirements.
- On average, Liquidity Funding accounted for only c.$3.3bn of average funding requirements of over $200bn (1.6%) during the sample period.



Note 1: at least five ABCP conduits were or are in the process of being wound up during the sample period. This may skew the reported liquidity draw figure to the high side because at some point in the wind-up process, an issuer may not choose to, or may not be able to, market its ABCP.

Note 2: sponsors who are also dealers of ABCP will, as a matter of course, retain ABCP inventory for market-making purposes. Dealer members were asked to remove this inventory when reporting.

Note 3: liquidity draws primarily occur for two reasons:

1. a genuine market-disruption type event; or
2. as a funding preference where the cost of funding via LIBOR-based liquidity is more efficient than the current market price for ABCP.

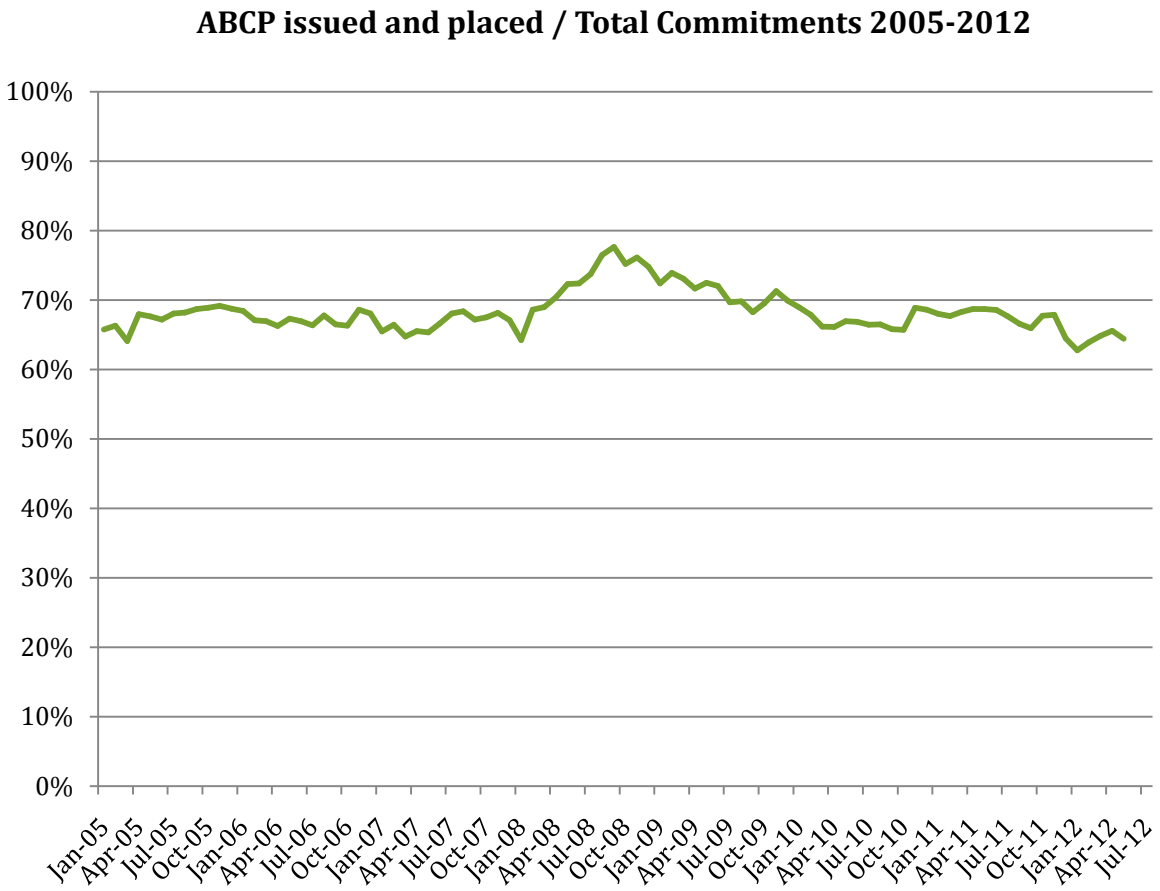
Section 3

LIQUIDITY SUPPORTING THE UNUTILISED PORTION OF TOTAL COMMITMENTS

ABCP issuance as a % of Total Commitments remains stable

Jan-05 to Jun-12

- ABCP issuance is constrained by the borrowing base of the assets of the seller; if good quality receivables are not available, ABCP cannot be issued and within a funding cycle there is no risk of the associated liquidity facilities being drawn.
- Of course, ABCP will vary from month to month as the volume of eligible receivables changes. Over time, therefore, and across funding cycles, liquidity could be at risk of being drawn as the Unutilised Portion becomes utilised.
- However, historical data shows that utilisation by sellers has averaged 68% for the sample period, with a standard deviation of 2.94%.
- The Utilised and Unutilised Portion has therefore remained relatively stable throughout the sample period.

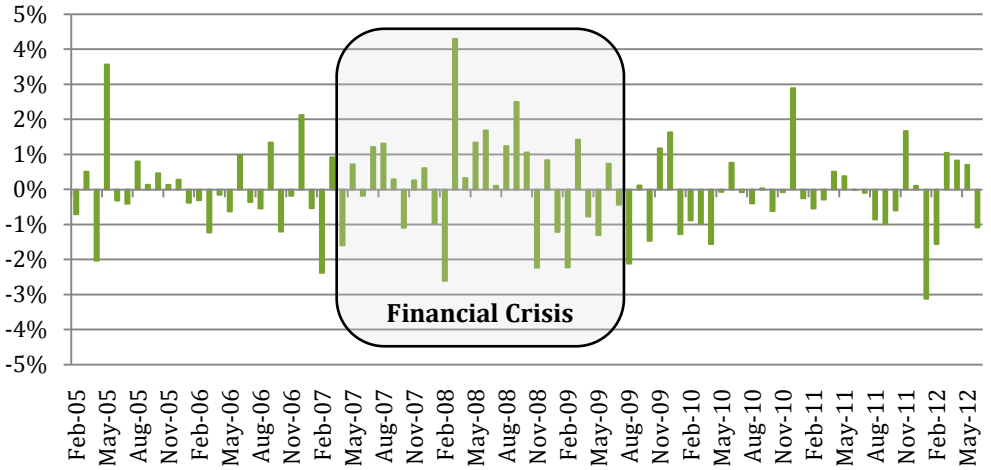


Highest monthly change in Utilised Portion = 4.34%

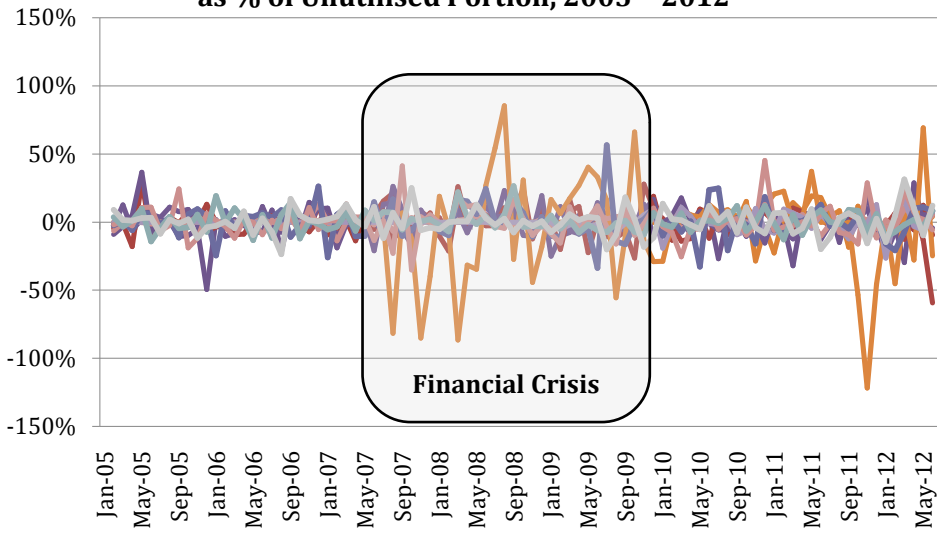
Jan-05 to Jun-12

- Number of observations: 2,403.
- Month over month variations in the Utilised Portion at an aggregate and sponsor level were tracked to assess the correlation between market stress during the financial crisis and increased utilisation of Total Commitments.

Monthly change in Aggregate Utilised Portion as % of Total Commitments, 2005-2012



Change in Sponsor Level Utilised Portion as % of Unutilised Portion, 2005 - 2012



- Low correlation was found during the sample period. This was because the borrowing base restricts increases to the underlying programs, and also because of reduced economic activity.
- Note that the graph on the left reflects not only underlying changes in the Utilised Portion but also an arithmetical feature which tends to exaggerate volatility.
- For example, assume Total Commitments of 100 of which 90 is utilised (and 10 unutilised) in Period 1. In Period 2 the Utilised Portion increases to 95. This is shown in the graph as a change of 5 / 10 = 50%. Yet the absolute amount of the extra Utilised Portion is relatively small.

Section 4

SUMMARY OF DATA, CONCLUSIONS AND REQUEST

Summary of data and conclusions

- The strong liquidity performance of ABCP Conduits, supported by the data in this document, warrants consideration for relief in the form of an adjusted calibration under Article 412 on:
  - liquidity supporting the Utilised Portion; and
  - liquidity supporting the Unutilised Portion.

- For the Utilised Portion, Liquidity Funding was never more than 5.45% of the Utilised Portion of Total Commitments.

- For the Unutilised Portion:
  - at an aggregate level and as a percentage of Total Commitments, the monthly variation in the Utilised Portion never exceeded 4.34%;
  - expressed as a percentage of the Unutilised Portion, this monthly variation never exceeded 13.72%;
  - applying the same methodology but at the individual sponsor level, the data showed an average monthly variation in the Utilised Portion of 8.13%;
  - using a percentile analysis to focus on the more likely scenarios, the 95th percentile in the monthly variations is no more than 16.62%.

- Neither the Utilised nor Unutilised Portions are therefore susceptible to "runs".

- Yet the currently proposed calibrations have the unwarranted consequence of severely penalising multi-seller asset-backed commercial paper conduits ("ABCP Conduits") which:
  - have a 30 year operating history
  - have exhibited strong liquidity performance even during times of stress
  - fund the real economy: trade receivables, auto and consumer loans with good performance
  - are supported by sponsor banks, and
  - are relied upon by customers as a significant source of working capital

AFME's request

- Given that the current proposed LCR calibration exceeds these levels of historical drawings by many multiples, AFME respectfully requests:

  - further dialogue with the European Commission, the Basel Committee and other stakeholders to resolve these difficult technical issues; and

  - in any event, a commitment to a review to be undertaken by the EBA of the proposed calibration during an agreed observation period.

Offices

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