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To: regs.comments@federalreserve.gov; [Comments](#); regs.comments@occ.treas.gov
Subject: WFE response to the notice of proposed rulemaking concerning the Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts
Date: Monday, March 18, 2019 8:26:46 AM
Attachments: [SA-CCR response for US authorities 20190318.pdf](#)
[wfe-consultation-response-on-committees-incentives-to-clear-7-september-2018.pdf](#)

Dear Sirs / Mesdames,

I write from the World Federation of Exchanges in response to the notice of proposed rulemaking concerning the Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts.

Attached here is our response, which makes the following points:

- The WFE supports a policy framework that allows for supports accessible, competitive and vibrant derivatives markets - and one that also ensures the soundness of banks (including the prevention of excessive leverage);
- The WFE has long advocated for the recognition of client margin offsets, and encourages international proposals to address the leverage ratio treatment of a segregated client margin; and
- The WFE supports the US authorities' efforts towards the implementation of the standardized approach for measuring counterparty credit risk (SA-CCR); provided this should be done in a manner that incorporates margin offsets.

Also attached here, for your reference, is our response to the Derivatives Assessment Team's consultation on incentives to clear, which was submitted in September 2018. In this, we make the following points:

- The WFE welcomes careful study of the impact of the important post-crisis reforms to OTC derivatives markets. Whilst agreeing that reforms have generally contributed to incentives to clear, the WFE urges concerted action to resolve the persistent issues with the way the leverage ratio treats segregated client initial margin.
- The WFE agrees with the report's analysis that, left unmodified, the leverage ratio poses disincentives to client clearing, as the current calculation fails to recognise the exposure-reducing impact of segregated client initial margin. This can render the provision of client clearing uneconomical, driving participants from the market and reducing access to hedging products, potentially increasing risk in the system. The solution is reforming the treatment of client initial margin under the leverage ratio by introducing an offset.
- The WFE believes that the Committees must now work together to deliver a globally consistent approach to the incentives regime and remediate the deficiencies identified in the report. We also call for a future study at the global level that considers the regime for clearing both OTC and exchange-traded derivatives.
- There are areas where implementation should be accelerated or better co-ordinated across jurisdictions, eg, with respect to introducing SA-CCR, particularly as it relates to the leverage ratio and to the calculation of PFE numbers for options. Furthermore there are areas where

we believe reforms could be revised and recalibrated to improve the regime overall, again with respect to the leverage ratio and Current Exposure Method.

If you require anything further, I remain at your disposal.

Best regards,

Richard

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WFE response to notice of proposed rulemaking on Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts

**FAO: Office of the Comptroller of the Currency; Federal Reserve System; Federal Deposit Insurance Commission
March 2019**

We welcome the opportunity to respond to US authorities' notice of proposed rulemaking on Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 200 market infrastructure offerings, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%). This includes over 50 distinct CCP clearing services, with everything from local entities in emerging markets to stand-alone CCPs based in major financial centres.¹

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

Authorities and market infrastructures concur on the necessity of a policy framework that allows for accessible, competitive and vibrant derivatives markets that also ensures the soundness of banks (including the prevention of excessive leverage). We believe that major jurisdictions should move in an expeditious and coordinated way to implement SA-CCR with segregated client margin collateral being permitted to reduce the leverage exposure measure under the Leverage Ratio. We therefore welcome jurisdictions moving to SA-CCR and urge the authorities to act to address the well-known challenges related to the leverage ratio treatment of client cleared derivatives (i.e. by permitting offsets for segregated client margin collateral under the Leverage Ratio). These challenges have been raised in numerous forums and by a diverse set of market stakeholders, including through academic work – including from [central banks](#) and [derivatives markets authorities](#)– and in the [findings of the Derivatives Assessment Team \(DAT\)](#).

As the WFE described in its response to the DAT:

- The failure of the current leverage-ratio calculation to recognise the exposure-reducing impact of segregated client margin collateral has reduced access to hedging products for end-users, potentially increasing risk in the system;
- It is striking at a time when the absolute and relative amounts of centrally cleared business have increased that the number of client-clearing operations has moved in the opposite direction;
- There is a risk that post-default porting will not be available to clients because it would not satisfy return on capital metrics of clearing members' parent organisations.

The reduction in client clearing services providers notably increases concentration risk and reduces access to clearing services for end users. The WFE collected data from six CCPs regarding the number of client clearing service providers active at their CCP in 2008 and 2018. These spanned the geographies of the WFE (i.e. 2 Americas, 3 EMEA, 1 Asia-Pacific) and included both large and small CCPs. Excepting one newly formed CCP (APAC CCP 1), four of the remaining five (Americas CCP 1, Americas CCP 2, EMEA CCP 1 and EMEA CCP2) saw the numbers of client clearing service providers remain flat or decline. EMEA CCP 3 had an overall rise in the number of client clearing services providers, though this was significantly less than the rise in entities clearing on their own account. The CFTC's data finds a decline in the client clearing service providers in the US over the period (from 139 to 64). Our belief that the lack of recognition of initial margin has contributed to this decline is substantiated by the DAT:

"Analysis of quantitative and qualitative survey data and market outreach suggest that the treatment of initial margin in the leverage ratio can be a disincentive for client clearing service providers to offer or expand client clearing."²

We believe that major jurisdictions should move in an expeditious and coordinated way to implement SA-CCR with segregated client margin collateral being permitted to reduce the leverage exposure measure under the Leverage Ratio. The solutions

¹ The WFE membership list [can be found here](#).

² Financial Stability Board, [Incentives to centrally clear over-the-counter \(OTC\) derivatives](#), November 2019.

proposed (Options 2 and 3) by the BCBS in their recent consultation would bring policy coherence to the Leverage Ratio, aligning the position of offsets for client-cleared derivatives with the position of securities financing transactions.³ These reforms would ameliorate the risk management challenges described above, while keeping intact the important improvements made to the prudential regime for banks under Basel III. We also note that a coordinated implementation of SA-CCR should include a focus on consistent terminology as well as a careful understanding of the differing structural features between types of listed derivatives that will be implicated by SA-CCR.

Within clearing member units of banks, the proposed changes would reduce client-related leverage ratio exposures substantially, calibrating the capital charge to more accurately capture the leverage implied by these transactions. Nevertheless, at the group level, the biggest banks clearing at CCPs will only be able to reduce their Tier 1 capital buffers by 1 per cent. Just as internal model approvals apply at the level of individual desks within banking organisations, banking supervisors will still be able to supervise and stress-test the leverage taken in client-clearing on a case-by-case basis.

Given the DAT's finding that even fewer organisations are likely to offer client-clearing in the future if reforms are not enacted, it is of utmost urgency that the US and international authorities act now to reform the leverage ratio and recognise the risk-reducing impact of margin. We urge authorities to monitor whatever changes are made to the leverage ratio on an on-going basis for their impact on client clearing services provision, particularly regarding concentration of client clearing services provision and other barriers to client clearing that may become apparent.

³ "The final standard [relating to securities financing transactions] now allows limited netting with the same counterparty to reduce the leverage ratio's exposure measure, where specific conditions are met." Basel Committee on Banking Supervision, [Basel III leverage ratio framework and disclosure requirements](#), January 2014.

September 2018

WFE Response to ‘the Committees’ (BCBS, CPMI, FSB, IOSCO): *Incentives to clear OTC derivatives*



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Incentives to centrally clear over-the-counter derivatives BCBS, CPMI, FSB, IOSCO – August 2018

Introduction

The World Federation of Exchanges (WFE¹) welcomes this analysis of the impact on the financial system of important reforms introduced since the FSB Commitments of 2009 and intended to increase resilience by making derivatives markets safer and more transparent.

We particularly support the Committees' continuing assessment of incentives to clear for the following reasons.

1. The evaluation embarks on a principles-based approach and shows sensitivity to some significant details, notably the importance of progress on amendments to the leverage ratio as it touches on margining for central clearing. Consistent with industry feedback, the report appears to conclude that the leverage ratio continues to be one of the most significant roadblocks, implying that concerted action to fix this is now necessary.
2. The Committees are well placed to promote a globally consistent process of optimisation of the incentives regime, building on a post-2009 reform agenda that was itself global in nature; and addressing the fact that the clearing landscape remains global.
3. Market operators have learned a considerable amount about the practical implications of the post-2009 framework, providing a basis to move beyond reaction to the Crisis and towards a steady-state regime that could optimise the incentives to clear over the longer term, provided of course the current round of reforms is properly implemented.

Looking ahead, the WFE believes that it would be helpful for the Committees to develop an action plan, building on the conclusions of the evaluation. We also believe that at least one further, broader and simultaneously deeper, more detailed iteration of this work on incentives assessment is desirable, given that so much depends on a well constructed system. There is a case, in our view, to look across the whole cleared business, exchange-traded (or 'listed') and OTC alike; and to do so in a more granular fashion, examining the capital and resource allocations that financial intermediaries are in practice making, down to the level of desks and departments. Such analysis should look systematically and comprehensively at all factors within the capital regime.

We provide answers to the questions set out in the evaluation paper (see below), but would appreciate the Committees' attention on the following more general remarks too.

General considerations

¹ The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 200 market-infrastructure offerings, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%). This includes over 50 distinct CCP clearing services, with everything from local entities in emerging markets to stand-alone CCPs based in major financial centres. (See [Member list](#).) With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

As an overarching proposition, the WFE believes that it is crucial to appropriately incentivise clearing. The assured and central role that CCPs played during the Crisis demonstrated to market participants and policymakers the systemic benefits that CCPs have long provided.

Subsequent global policy measures, however, appear to have altered not just the *relative* costs of central clearing and bilateral arrangements but also the absolute costs of clearing, whether for listed or OTC business. While some costs will certainly be justified, it is important to ensure that these are carefully calibrated, not least because that the number of clearing members serving clients has fallen at just the time when the volume of clearing has risen.

On the other side of this analytical ‘balance sheet’ are the (systemic) benefits that clearing provides, along with any incremental improvements in liquidity and costs of trading for more standardised instruments. These are particularly effective in relation to the activities of certain key participants – participants whose activities give rise to portfolios with a high degree of natural offset of market-risk positions. But the system can in principle also benefit from clearing a) being extended widely, in terms of participants and b) being supported financially by as many participants as possible. As long as clearing (and each CCP) is managed to rigorous standards – which it demonstrably is – then the case for attracting a wide a range of participants is strong.

In particular, greater participation might result in greater reduction of risk exposures via multilateral netting. Where this net-down is feasible (in the sense that offsets are there to be crystallised within a given participant’s own portfolio), it can bring obvious benefits for the system as a whole, as well as to the individual CCP and its members.

Unfortunately, as the consultation paper acknowledges, the reduction of risk exposures is not feasible in the same way for those clients that have a ‘directional’ book (rather than one with natural market-risk offsets)². Yet it remains desirable to be able to incentivise such ‘directional’ participants in the first place; and then, as necessary, port them from a defaulting clearing member to a solvent one. This makes the calibration of certain aspects the capital rules a key factor; and one that should be addressed on a globally co-ordinated basis, just as the reaction to the Crisis was global.

Most pressing, the Committees should in our view prioritise globally co-ordinated action in two main areas:

- i) recognition of the exposure-reducing effect of margin posted on behalf of clients, specifically within the leverage ratio, where segregation and limits on re-use of collateral apply – an issue across instrument types in all asset classes; and
- ii) the inappropriateness of referencing only the notional amount in calculating potential future exposure (PFE) numbers for options, as happens under the CEM, when the option’s delta is clearly the most relevant factor in determining PFE;

In order to avoid the risk of future incoherence, the Committees should take into account the knock-on effects on ported credit exposures.

One of the findings of the G20 process following the Crisis of 2008-09 was that collateralisation (margining) of positions was a form of best practice that could be applied more widely. At the same time, however, the capital rules on leverage, while welcome in concept as a form of backstop measure, do as

² If such participants are not under the capital regime, reductions in risk weightings of assets will not be relevant

currently formulated frustrate that objective and add a regulatory cost on top of an existing economic cost of collateral.

While our main focus in this response is on this capital dimension, we do recognise the impact of bilateral margin rules (as illustrated clearly by the evidence presented in the paper relating to the NDF market) and urge the Committees to push for implementation to be completed promptly and uniformly around the world. We also acknowledge that the clearing mandate has played some role in increasing uptake of clearing and urge the Committees to consider the important behavioural message and the regulatory signal of intent that it sends by maintaining mandates.

As regards the costs of clearing, while we argue in this response against what we believe to be unwarranted costs that are an unfortunate by-product of the existing standards, we do stress that costs are not an inherently bad thing. For one thing, in order to see the full picture, costs should be of course be analysed alongside the benefits that those costs bring. Within that framework of proportionality, the WFE believes that it is preferable to have costs that are certain in scale and timing – as occur in the clearing context – to those that are un-certain in either scale or timing. Hence our emphasis on a careful calibration of costs. In other words, our comments should not be construed as systematically saying that costs could or should *a priori* be lower, even though in some instances we firmly believe they should indeed be lower.

More generally, we are not currently in a position to add to the raw data that individual CCPs or participants will provide. However, we believe the study has already uncovered significant data and the key issue is now prompt and effective action, where policy issues have been identified.

Overall, we believe that both DAT exercises have been extremely useful to authorities (we assume) and to the market, and that follow-on work is now required. In addition to prompt and concerted action to remediate the deficiencies identified in the capital regime, that should in our opinion include a future study – again, at global level – that considers the regime for clearing both OTC and exchange-traded derivatives. Some intermediaries and CCP operators are active in both (as well as in unclearable products, for which residual demand apparently remains) and some factors affect both sectors, making it feasible and desirable to paint a fuller picture. Such a study could usefully encompass how the capital regime impacts decision-making about what services banks offer and to whom.

In order to be meaningful, the analysis must also look comprehensively at all of the inter-related factors that determine the take-up of clearing, without exception and without being selective. This in practice means revisiting the treatment of the exposures that would be crystallised under porting – a topic that the evaluation paper acknowledges as meriting some attention. From a client's perspective, there is a risk that porting stops being available (because it is not cost-effective, in capital terms, for clearing members to offer). Yet this defeats a major objective of clearing for clients, namely to provide continuity of contract upon the occurrence of a 'Lehman' event.

This problem is rooted in the failure to recognise exposure mitigation (at least where SA-CCR, with client initial margin offsets, is not adopted for leverage purposes, meaning that a clearing member that accepts a ported client cannot even achieve portfolio efficiencies in the form of offsets between margin and exposures). Even if all current clearing clients could switch to direct membership of CCPs (which we do not believe to be practical), it would still be desirable to have a regime for client clearing that better accommodated porting, increasing the incentive for new participants to come to clearing.

Where relevant, the future analysis could also consider other factors beyond the scope of the current evaluations, including any considerations relating to market transparency, the integrity of price formation,

market liquidity (and trends therein) and risk concentrations, together with the operation of related regulatory requirements to trade on platforms and to report positions to trade repositories.

Responses to specific questions in the evaluation paper

A note on the questions that we have focused on primarily

Our response to this consultative report focuses in large part on the capital regime for banks. Banks are key intermediaries in all derivatives (listed and OTC and across asset classes) and the report demonstrates that, in many instances, the regulation of banks is the key driver of both incentives to clear and the accessibility of clearing services. We request that the Committees strongly encourage relevant authorities to take prompt action via updated international standards to address those areas already highlighted by the DAT where the policy framework requires adjustment. The leverage ratio and current exposure method are both areas of urgency in this regard and the Committees behind this consultation should, in our view, press for such action. Now that a considerable body of evidence demonstrates the issues with CEM as well as the leverage ratio, we believe that it is desirable to address these long-standing issues definitively at the global level, while pushing for them to be addressed in a co-ordinated way across jurisdictions.

Question 1: Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?

Based on first principles and the data collected by the DAT, we agree that there are relatively strong base incentives to clear for dealers, insofar as the multilateral net-down is in practice largest for this category of participant. There are some weaker incentives for clients that are ‘directional’. (While a client’s size may coincide with the natural risk offsets that can be crystallised via clearing, it will not necessarily give rise to any. In light of this, the way the current capital system is calibrated appears to work worst for large clients, even if they would prefer to clear, unless they happen to have such offsets. Should such a large client default, then the impact on financial stability will be greater, the more of their activity is outside the centrally cleared system. Moreover, to the extent that bilateral margin rules are not fully implemented in a given jurisdiction, then the mismatch between the cleared and non-cleared regimes would be problematic.)

Question 2: Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report’s characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?

We believe reforms have generally contributed to incentives to clear. There are areas where implementation should be accelerated or better co-ordinated across jurisdictions, eg, with respect to introducing SA-CCR, particularly as it relates to the leverage ratio and to the calculation of PFE numbers for options. Furthermore there are areas where we believe reforms could be revised and recalibrated to improve the regime overall, again with respect to the leverage ratio and Current Exposure Method.

The policy issues are dealt with in greater detail in our responses to question 4.

Question 3: Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?

The bilateral exchange of margin for uncleared derivatives will – alongside the regulatory capital associated with uncleared transactions – act as an incentive to clear. In jurisdictions where bilateral margining has not yet been introduced, that process should be completed, notably with the implementation of the rules on exchange of initial margin. Moreover, the calibration of the bilateral margin regime, relative to margining in the cleared world, should remain under review, if it is to continue to push participants towards central clearing.

Future assessment of incentives to clear could include a more granular analysis, with side-by-side comparisons of the costs of cleared and uncleared products and the resources that intermediaries dedicate to various departments. This would in principle cover the cost of capital, including expected returns on capital for dealers and intermediaries.

Question 4: The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.

The issues we regard as most important and urgent related to incentives to clear are the treatment of initial margin under the leverage ratio and the lack of risk-sensitivity for options under the Current Exposure Method. We cover these and certain other issues below.

Leverage Ratio

We believe that client initial margin that is segregated should be recognised in the capital regime as reducing the leverage exposure measure.

We concur with the report's analysis that, left unmodified, the leverage ratio poses problematic disincentives to client clearing. Collateral posted by a client to a bank to support clearing is subject to protection within the CCP's rulebook (and regulatory framework) and often the regulatory framework for banks. This is further evident where the collateral may not be re-used ('rehypothecated') by the bank, and (in the case of non-cash collateral) must be held in a separate, segregated account that may be bankruptcy remote (ie, not tied up in the event of the bank's own bankruptcy proceedings). It therefore differs from other bank assets; indeed, for accounting purposes, margin received from clients may not even appear on a bank's balance sheet. Please note that collateral associated specifically with cleared OTC transactions is frequently passed on to the CCP, at which point it is outside the ownership and control of the banks intermediating the cleared OTC transaction.

Notwithstanding this, the Basel Accord rules concerning the leverage ratio include initial margin in the relevant calculation of a bank's assets (known as total leverage exposure). The failure of the current

leverage-ratio calculation to recognise the exposure-reducing impact of client collateral held by a bank – where it meets requisite criteria – has made the provision of client clearing services uneconomical for some banks, driving them from the market. This has in turn reduced access to hedging products for end-users, potentially ultimately *increasing* risk in the system.

The capital treatment for banks' exposures to CCPs was appropriately modified for the calculation of risk-weighted assets. The same logic should apply to the leverage-ratio calculation.

Current Exposure Method (CEM) and option delta

The unqualified use of only the notional creates unnecessary problems with regards to calculating potential future exposure (PFE) numbers for options contracts. As is well documented, the delta of a given option indicates the *effective* size of that option, expressed as a percentage of the notional amount. This effective size can be anywhere from ~0% to ~100% of the notional, as a function of the relative level of the strike price and price of the underlying³. By extension, an option's delta also indicates the amount of the underlying asset that the writer of that option would trade, if she wished to hedge its sale. In other words, the delta is not a theoretical construct but a real-world number. So, ignoring it pushes up costs for market participants unjustifiably. (At the margins, it could also increase incentives among market participants to instead revert to 'portfolio insurance' – the pro-cyclical technique that mimics options via delta-weighted trading in the underlying and which exacerbated the October 1987 stock-market crash.)

Thus, the CEM is a poor means of calculating risk for options because it fails to account for delta. The lack of risk sensitivity in the capital treatment of options under CEM engenders unhelpful distortions to trading operations as well as clearing.

Current Exposure Method and netting: i) netting sets and ii) PFE netting

To achieve the risk reduction associated with netting, CCPs net exposures within designated 'netting sets'. Unfortunately, the CEM does not allow for the same netting sets for bank capital purposes as CCPs are able to deploy for margin for the same portfolio. This is an unhelpful double-standard, without an obvious policy rationale. It in effect means that participants face higher costs for the same risk.

Furthermore, even the allowable netting sets under CEM only reduce future exposure by 60%. If this factor were better aligned with SA-CCR it would more appropriately represent the associated risks. CCPs clear only liquid markets with homogenous netting sets of relatively standardised instruments with relatively high levels of correlation. The scope for the net exposure value within such a netting set to vary is inherently much more limited than is the case for a wider range of asset classes, such as the diverse OTC exposures that may be included within an ISDA Master Agreement. As the latter can cover any and every asset class, PFEs for such heterogenous portfolios should indeed reflect the possibility that market-risk offsets may reduce over a given time period. This justifies the application of a 'haircut' (under the CEM) to the recognition of netting of PFE numbers. However, where the netting set is more liquid, the haircut could be reduced (from 40% to, say, 25%); and where it is both liquid and homogenous, then we believe that the haircut (on the recognition of netting) could reasonably fall to 15%.

Of course, to the extent that SA-CCR is introduced uniformly around the world, there is a better alignment with risk and less scope for distortions across the global clearing business.

³ If an option is deep in-the-money (eg, a purchased call option with a strike price of \$10, when the spot price of the underlying asset is \$100), it will have a delta close to 1, denoting that the value of the option will change nearly 1:1 with the price of the underlying. But if the purchased call option had a *strike price* of \$100 while the price of the *underlying* was \$10, the delta would be close to zero and changes in the option's value would be a minimal fraction of changes in the price of the underlying.

Absent a better approach to netting sets, there is a clear risk not only of higher costs in clearing but reduced liquidity in both the relevant derivatives markets and the underlying ‘cash’ markets for which those derivatives serve as risk-management tools.

Other issues

The **Large Exposures Regime** should take account of the different character of CCPs compared to other counterparties, and overarching policy objective of efficient central clearing; for example by exempting CCPs as counterparties in this regime. A bank utilising a CCP ought not be disincentivised from further utilising one because of restrictions imposed by the large exposures regime.

Net Stable Funding Ratio specifies that Available Stable Funding (ASF) should be greater than or equal to Required Stable Funding (RSF). RSF is calculated by applying percentage ‘factors’ to asset values; these factors are meant to reflect the relative riskiness of the assets in question. For example, monies deposited at a central bank have a factor of 0%, while non-performing loans have a factor of 100%.

When it comes to amounts posted as IM or contributions to a CCP default/guaranty fund, an 85% factor applies⁴. Yet default of a (fellow) clearing member remains a remote possibility and is presumptively even less likely, given changes since 2009 to the bank recovery and resolution regimes. Moreover, evidence from 2008 shows that it was possible to manage the default of a large clearing member without going further in the waterfall than that member’s own initial margin contributions. So, while we agree strongly with the principle that CMs should be able to cover any losses that were to materialise in relation to default-fund contributions; and while default-fund contributions are not in aggregate huge in comparison with other exposures that banks incur across their business as a whole; the ability of a CCP to return assets to a (non-defaulting) clearing member that wanted them is strong, especially as a CCP will limit its clearing services to those instruments that are relatively liquid and in which it is therefore easier to close out positions⁵.

We suggest that a 50-65% factor might be appropriately prudent for the RSF for IM and default-fund contributions; and we stand ready to work with global authorities for further analysis of a risk-sensitive factor that promotes appropriate incentives in the default waterfall as a whole.

Further analysis

We concur with the suggestion in the report that “further analysis of the economics of client clearing and the relevant standards and their interaction with non-regulatory factors may be warranted in order to understand better the role of regulation in this phenomenon and whether policy action is merited given the authorities’ objectives.”

Question 5: Is the consultative report’s characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?

We are currently not in a position to comment on this authoritatively.

⁴ The 85% RSF factor applies to “cash, securities or other assets posted as initial margin for derivative contracts and cash or other assets provided to contribute to the default fund of a CCP”.

⁵ It is also true that non-defaulting clearing members may be able to influence outcomes to some extent, since they can bid for a defaulting CM’s book. That book may of course contain offsets against existing positions in the book of a non-defaulting CM.

We note that clearing depends on liquidity in the instrument in question, as well as having the ability to reinforce it.

Question 6: There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?

Ultimately, we view these issues as second-order. They might reduce some costs for some participants to some extent but, to keep things in perspective, please note that the operation of the leverage ratio affects the whole cleared universe much more.

Even if direct clearing models prove attractive, we believe that it is important to correctly incentivise the model whereby activity passes through a clearing member.

Compression should, in principle, improve the attractiveness of clearing but is not exclusive to the cleared environment and can only apply once portfolios have built up, leaving some issues and challenges in place. (In any case, the extent of the impact of compression may depend on the specific model applied.)

Please see our response to question 12 for more comments on issues relating to cost.

Question 7: Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?

- a) central clearing mandates (both in terms of product scope and entity scope);
- b) minimum standards for margin requirements for uncleared derivatives;
- c) capital requirements for credit valuation adjustment (CVA) risk;
- d) capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));
- e) G-SIB requirements; and
- f) The leverage ratio.

While we broadly agree with the report's characterisation of the items listed in the question and place special emphasis on the leverage ratio – including related G-SIB requirements—and on the CEM, we are focused most on how to ensure action is now taken, particularly on point 'f', the leverage ratio. *A fuller discussion of these issues can be found in our response to question 4.*

As stated in *our response to question 3*, in jurisdictions where bilateral margining has not yet been introduced, it should be, and promptly.

It is important that SA-CCR be implemented in a co-ordinated way across jurisdictions, so as to avoid regulatory arbitrage, uneven incentives to clear and increased complexity in what remains an international system.

Question 8: Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

We remain concerned that the current regulatory framework has shortcomings that are damaging incentives for clients (either directly or in consequence of capacity issues from intermediaries).

Question 9: Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

Please see our response to question 11 below.

Question 10: Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in: a. accessing clearing arrangements; and b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

The report correctly characterizes the difficulties faced by clients (generally and those that are directional).

Question 11: Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

A certain amount of concentration is natural in the provision of client-clearing services, partly because the economics of the business favour larger-scale operations and partly because of other barriers to entry, notably regulatory requirements. Having said which, it is striking at a time when the absolute and relative amounts of centrally cleared business have increased that the number of client clearing operations has moved in the opposite direction.

The impact on client access of the present regulatory framework is well articulated in the report and bolsters the case for ensuring – promptly and definitively – that the leverage ratio works properly. We believe that, if both client clearing and direct clearing are available to a variety of financial institutions without undue constraints from the leverage ratio, a more appropriate environment for clearing membership and client clearing will prevail.

Question 12: Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of: a. using clearing services? b. providing client clearing services?

We cover a number of points about costs in our introductory section. These are reproduced below (within quotation marks).

One additional if perhaps unsurprising point is that high fixed costs, such as costs of selecting a clearing member and connecting to its systems, may of course act as more of a disincentive for a smaller client than for a large one. For larger clients, there will conversely be economies of scale.

The bigger picture also matters. It is conceivable that some participants choose simply to reduce their use of derivatives of any sort, included those that are centrally cleared. We do not see any evidence that such an outcome was the intent behind the G20 reforms; or that it would in fact be desirable. The ability of the financial system – particularly in its post-2009 form – to absorb, reduce and mitigate credit risk is greater than the pre-2009 version, while derivatives remain highly relevant in a volatile world⁶. While the use of some types of derivative may necessarily entail higher costs than in the past, that does not mean costs should be set arbitrarily and indiscriminately across all types of mechanism for handling the risks associated with derivatives.

“Policy measures appear to have altered not just the *relative* costs of central clearing and bilateral arrangements but also the absolute costs of clearing, whether for listed or OTC business. While some costs will certainly be justified, it is important to ensure that these are carefully calibrated, not least because the number of clearing members has fallen at just the time when the volume of clearing has risen.

One of the findings of the G20 process following the Crisis of 2008-09 was that collateralisation (margining) of positions was a form of best practice that could be applied more widely. At the same time, however, the capital rules on leverage, while not being objectionable in concept, do in practice add a regulatory cost on top of an existing economic cost of collateral.

As regards the costs of clearing, while we argue above against what we believe to be unwarranted costs that are an unfortunate by-product of the existing standards, we do stress that costs are not an inherently bad thing. For one thing, in order to see the full picture, costs should be of course be analysed alongside the benefits that those costs bring. Within that framework of proportionality, the WFE believes that it is preferable to have costs that are certain in scale and timing – as occurs in the clearing context – to those that are un-certain in either scale or timing. Hence our emphasis on a careful calibration of costs. In other words, our comments should not be construed as systematically saying that costs could or should *a priori* be lower; even though in some instances we firmly believe they should indeed be lower.

Future assessment of incentives to clear could include a more granular analysis, with side-by-side comparisons of the costs of cleared and uncleared products and the resources that intermediaries dedicate to various departments.”

Question 13: In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

As regards the entities covered, naturally any obligation to clear should be based on potential systemic impact. That does not however mean that the regime should not include (positive) incentives for smaller participants to clear, given the potential benefits to the system as a whole and to individual CCPs.

⁶ There are indirect benefits to clearing. It provides a stable core market, in which more sophisticated intermediaries can lay off risks that arise from other business that is not itself suitable for clearing.

As regards the product scope of the clearing mandate (as distinct from the question of which entities must clear), we do not have specific recommendations regarding the addition of any individual financial instruments.

The mandate appears to have reinforced the tendency to clear. It is hard to be completely sure by how much, since clearing of some OTC products was already growing by the time of the Lehman Brothers default. (Clearing even covered some of the OTC activity of Lehman Brothers itself and – as expected and in stark contrast to other parts of the system – worked notably well.) Moreover, factors other than the obligation to clear certain products are significant too. The imposition of bilateral margin rules – at least where these have actually been fully and promptly implemented – has clearly had an impact, most notably within the inter-dealer market, as illustrated in the evaluation paper.

We consider that on balance the clearing mandate is likely to have been most helpful in focusing attention on clearing and speeding up the uptake among certain participants. At this stage, we believe that the priority should now be to take action to remove those factors that interfere detrimentally with the normal economics of this business – especially the treatment of segregated client IM under the leverage ratio. Maintaining the existing clearing will nonetheless send a strong behavioural message, reinforcing the trend towards clearing.

Strictly speaking, the regulatory landscape consists more of obligations and dis-incentives for *not* clearing (notably the bilateral margin rules and higher risk weights). This tends to obscure questions of true, positive incentives to clear, which we believe are likely to be a highly significant factor in the longer run. We have already seen a drop in the number of clearing members since the Crisis (and since the introduction of wider clearing of OTC products), and we do not believe this to be a healthy or helpful phenomenon.

We also note in passing that CCPs should retain a right of *refusal* to clear products and the discretion to set the terms on which clearing does happen, subject of course to supervisory oversight, itself based on internationally agreed standards and a streamlined process of mutual cross-border recognition.

Should standard setters feel a need to revisit the clearing mandate, the most logical instruments to consider would be products that will most readily give rise to offsets against products that are already being cleared. In line with our comment in the paragraph above, CCPs must be in a position to ensure that any such products meet the same criterion of liquidity as those that are currently mandated.

Question 14: Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

Please see the first part of our answer to Question 13 for our comments.