January 15, 2019

Comments on the Consultative Document
Leverage ratio treatment of client cleared derivatives

Japanese Bankers Association

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the Consultative Document *Leverage ratio treatment of client cleared derivatives* published on October 18, 2018 by the Basel Committee on Banking Supervision (BCBS).

We respectfully expect that the following comments will contribute to your further discussion.

<<General Comments>>

We would like to pay our respect to the efforts undertaken by the BCBS, Financial Stability Board (FSB) and other standard-setting bodies concerning the impact of the margin treatment in the leverage ratio on client cleared derivatives, which include continuous monitoring, analyses based on quantitative/qualitative survey results, and discussions with market, etc. We support the BCBS's proposal to review the leverage ratio treatment of client cleared derivatives.

Under the current leverage ratio framework, margin's risk mitigation effects are not taken into account for client clearing service providers (CCSPs). Therefore, an increase in transaction volumes leads to adverse effects on the leverage ratio, and as a consequence, it disincentivises entities to provide the client clearing service. FSB and other standard-setting bodies noted this point in their report titled *Incentives to centrally clear over-the-counter (OTC) derivatives* published on November 19, 2018 ("FSB, etc. Report").[1] If CCSPs constrain their client clearing business, transaction costs may increase across the entire financial institutions. This may lead to adverse effects, including a decline in financial institutions' risk-based capital adequacy ratio.

Revisions to the leverage ratio treatment will not only reduce the disincentive for financial institutions to offer client clearing services, but also reduce burdens of those financial institutions who act as a clearing broker in central clearing business, and it would ultimately improve the environment to promote central clearing.

[1] FSB and standard-setting bodies publish final report on effects of reforms on incentives to centrally clear over-the-counter derivatives
http://www.fsb.org/2018/11/incentives-to-centrally-clear-over-the-counter-otc-derivatives-2/

From the above viewpoint, of the three options proposed in the Consultative Document, we support the following two options: Option 2 which allows amounts of cash and non-cash initial margin that are received from the client to offset the potential future exposure of derivatives centrally cleared on the client's behalf, or Option 3 which permits both cash and non-cash forms of initial margin and variation margin received from the client to offset replacement cost and potential future exposure for client cleared derivatives only.

<<Specific Comments>>

(Questions)

1. Is there concrete and robust empirical evidence that would warrant a revision to the leverage ratio treatment of client cleared derivatives?
2. To what extent would the two potential revisions discussed in this consultative document adequately meet the G20 Leaders' policy objectives of strengthening the resilience of the banking system by preventing excessive leverage and promoting central clearing of standardised derivative contracts?
3. What are the potential forward-looking behavioural dynamics of the client clearing industry that could occur as a result of possible changes to the leverage ratio treatment of client cleared derivatives?

(Our response)

In general, the following two regulations are raised as major constraints on CCSPs in central clearing of derivatives as well as factors that ultimately undermine the promotion of central clearing: (i) capital charge treatment for clearing funds; and (ii) the leverage ratio treatment. We welcome the proposed revisions by the BCBS in the view that it will contribute to reducing such constraints described in (ii) of the above.

As indicated in the FSB, etc. Report, in the leverage ratio framework, expanding the client clearing service leads to adverse effects on the leverage ratio of CCSPs themselves, and thus it is a disincentive for them to offer such a service.

Given the following points in addition to the above, the disincentive for CCSPs to provide client clearing services may further increase in the future.

・An increase in the needs to backload existing non-centrally cleared transactions to Central Counter Parties (CCPs) as a result of the expansion of the margin rules (that cover non-centrally cleared OTC derivatives)

・Introduction and expansion of mandatory central clearing in some jurisdictions, such as Singapore[2] and Hong Kong (AUD swaps)[3]

The above points are factors that increase centrally cleared transactions and many of the increased transactions would be centrally cleared via client clearing provided by CCSPs. However, under the circumstance the current leverage ratio framework is being a disincentive for client clearing, we are concerned that central clearing will not be promoted as expected.

Moreover, the disincentive will further aggravate the issues raised in the FSB, etc. Report, including concentration of CCSPs and increasing costs, and could undermine the initial policy objectives of strengthening the resilience of the banking system by promoting central clearing.

It is assumed that solvency of CCSPs themselves can be achieved sufficiently under the current Basel III framework, and the revisions to the leverage ratio treatment proposed in this consultative document would expand the incentive for client clearing service provision and increase centrally cleared transactions, ensuring the solvency of CCSPs. In order to achieve this purpose, we believe it would be appropriate to adopt the proposed Option 2 or Option 3.

In addition, if, a CCSP does not deposit all of margin received from its clients to a CCP, and reinvests a portion of margin without segregating them, such practice should not considered to be the appropriate management of clients' assets. Therefore, in such a case, the offsetting should not be unconditionally permitted for either option.

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[2] MAS Requires OTC Derivatives to be Centrally Cleared to Mitigate Systemic Risk
http://www.mas.gov.sg/News-and-Publications/Media-Releases/2018/MAS-Requires-OTC-Derivatives-to-be-Centrally-Cleared-to-Mitigate-Systemic-Risk.aspx

[3] Regulators conclude consultation on further enhancements to the OTC derivatives regulatory regime
https://www.hkma.gov.hk/eng/key-information/press-releases/2018/20180627-4.shtml