



June 13, 2014

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**Re: Comment Letter on the Proposed Rule to Modify the Denominator of the U.S.  
Supplementary Leverage Ratio and the Enhanced Supplementary Leverage Ratio  
(Docket ID OCC-2014-0008; Docket No. R-1487 RIN AE-16; RIN 3064-AE12)**

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (“SIFMA”), the American Bankers Association, the Financial Services Roundtable, and the International Swaps and Derivatives Association (collectively, the “Associations”) appreciate the opportunity to comment on the proposed rule issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the “Agencies”), *Regulatory Capital Rules: Regulatory Capital, Proposed Revisions to the Supplementary Leverage Ratio*, 79 Fed. Reg. 24,596 (May 14, 2014) (the “Proposed Rule”). The Proposed Rule would revise the denominator of both the supplementary

leverage ratio (“SLR”) and the enhanced supplementary leverage ratio (“eSLR”) — the “total leverage exposure” — to more closely align with the international leverage ratio introduced by the Basel Committee on Banking Supervision (“BCBS” or “Basel Committee”) in 2010 (“Basel III leverage ratio”), as revised in January 2014 (the “BCBS 2014 revisions”). Specifically, the Proposed Rule would revise the treatment of on- and off-balance sheet exposures for purposes of determining total leverage exposure.

The Associations generally support the adoption of a supplementary leverage ratio as a backstop to the risk-based capital ratio applicable to banks and bank holding companies, as well as the need for a consistent ratio internationally. In this context, as described in more detail below, we believe the proposed treatment of certain exposures in the Proposed Rule should be clarified or adjusted in ways that would be consistent with the BCBS 2014 revisions, while at the same time reflecting actual economic exposure to risk of loss — because the fundamental purpose of the denominator of the supplementary leverage ratio is to capture such actual economic exposure. Indeed, SIFMA’s global affiliate, the Global Financial Markets Association (“GFMA”), the American Bankers Association, the Financial Services Roundtable, the International Swaps and Derivatives Association, and other trade associations submitted a letter on March 17, 2014 to the BCBS requesting clarifications of and adjustments to the BCBS 2014 revisions in the form of suggested answers to “Frequently Asked Questions” (the “Basel FAQ Submission”); many of the specific requests in this comment regarding the Proposed Rule are similar to those made in the Basel FAQ Submission, as noted below.

The Associations also believe, however, that in certain limited circumstances, the treatment of exposures in the Proposed Rule, although consistent with the Basel III leverage ratio, diverges substantially from actual economic exposure — and would result in the SLR/eSLR becoming the constraining ratio for many banking organizations, rather than a backstop. We have significant concerns with a risk insensitive ratio becoming the primary capital constraint on banks, as it creates perverse incentives to invest in higher-risk assets and reduce holdings of lower-risk assets.<sup>1</sup> We therefore believe that, in these limited circumstances, the Agencies should use their national discretion to deviate from the Basel III leverage ratio with carefully calibrated modifications to the Proposed Rule that would better capture such actual economic exposure. Such changes would be especially appropriate with respect to the total leverage exposure of the enhanced supplemental leverage ratio, which is a “U.S.-only” capital requirement that need not be consistent with the Basel III leverage ratio.

The changes proposed by the Associations are described below in the following substantive areas addressed in the Proposed Rule: (I) Netting of Cash Variation Margin; (II) Written Credit Derivatives; (III) Repo-Style Transactions; (IV) Credit Conversion Factors for Off-Balance Sheet Exposures; (V) Daily Averaging of Exposures; (VI) Certain Required Disclosures; (VII) Treatment of Cash in Total Leverage Exposure; (VIII) Treatment of U.S. Treasury Securities in Total Leverage Exposure; (IX) Exclusion from Total Leverage Exposure

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<sup>1</sup> See Letter from various trade associations to the Secretariat of the Basel Committee on Banking Supervision, Appendix 4 (September 20, 2013), available at <http://www.bis.org/publ/bcbs251/crovbafa.pdf>. The study referred to in this letter and reproduced at Appendix 4, commissioned by the GFMA and The Clearing House, assessed the impact of the proposed leverage ratio on banks and on relevant market products.

of Segregated Cash Collateral from Clients; and (X) Future Treatment of the Standardized Approach for Measuring Counterparty Credit Risk.

## **I. Netting of Cash Variation Margin**

The Proposed Rule provides that cash variation margin may be netted against the exposure created by a derivative contract, but only so long as five conditions are satisfied:

- (1) For derivative contracts that are not cleared through a QCCP [qualifying central counterparty], the cash collateral received by the recipient counterparty is not segregated;
- (2) Variation margin is calculated and transferred on a daily basis based on the mark-to-fair value of the derivative contract;
- (3) The variation margin transferred under the derivative contract or the governing rules for a cleared transaction is the full amount that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contract, subject to the threshold and minimum transfer amounts applicable to the counterparty under the terms of the derivative contract or the governing rules for a cleared transaction;
- (4) The variation margin is in the form of cash in the same currency as the currency of settlement set forth in the derivative contract. For purposes of this paragraph, currency of settlement means any currency for settlement specified in the governing qualifying master netting agreement, the credit support annex to the qualifying master netting agreement, or in the governing rules for a cleared transaction; and
- (5) The derivative contract and the variation margin are governed by a qualifying master netting agreement between the legal entities that are the counterparties to the derivative contract or by the governing rules for a cleared transaction. The qualifying master netting agreement or the governing rules for a cleared transaction must explicitly stipulate that the counterparties agree to settle any payment obligations on a net basis, taking into account any variation margin received or provided under the contract if a credit event involving either counterparty occurs . . .<sup>2</sup>

These conditions for the netting of variation margin should be clarified in the following ways, which the Associations believe would be consistent with the language and/or purpose of the BCBS 2014 revisions.

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<sup>2</sup> 79 Fed. Reg. at 24,609 (col. 1), 24,612 (col. 2); 24,615 (col. 2-3).

## A. Presumption Regarding Posted Cash Collateral

With respect to the first condition for netting, a banking organization that posts cash collateral with a counterparty that is not a QCCP may not know whether that counterparty has segregated the cash it has received. Accordingly, the Proposed Rule should be clarified so that a posting organization may presume that such a counterparty has *not* segregated the cash received unless required to do so pursuant to applicable legal requirements or contractual terms.<sup>3</sup>

## B. Effect of Small, Temporary Differences in Margin Provided

The third condition for netting requires that the variation margin be in the “full amount necessary to fully extinguish the current credit exposure amount to the counterparty of the derivative contract.” Sometimes, however, short-term timing differences result in small, temporary variations between the amount of variation margin provided and the mark-to-fair value exposure, *e.g.*, in the common case where a morning margin call is based on the mark from the previous day. Such small, temporary differences should not prevent the recognition of the amount of cash variation margin that has actually been provided, so long as it is clear that the contract governing such transactions requires variation margin for the full amount of the current credit exposure (minus threshold and minimum transfer amounts). For example, a small amount of margin outstanding, due to T+1 margin call arrangements, should not invalidate recognition of potentially much larger cash margin already received – the rule as proposed would cause instability by generating cliff effects and daily volatility from potentially very small amounts outstanding. Accordingly, the Proposed Rule should be clarified to permit such differences so long as it is clear that the contract governing such transactions requires variation margin for the full amount of the current credit exposure, as described above.<sup>4</sup> Specifically, the third condition should be modified as indicated in the emphasized text below:

The variation margin transferred under the derivative contract or the governing rules for a cleared transaction is the full amount, ***measured as of the time of the margin call***, that is necessary to fully extinguish the net current credit exposure to the counterparty of the derivative contract, subject to the threshold and minimum transfer amounts applicable to the counterparty under the terms of the derivative contract or the governing rules for a cleared transaction . . .

## II. Written Credit Derivatives

Under the Proposed Rule, a banking organization that provides credit protection in the form of a written credit derivative must include in its total leverage exposure the effective notional principal amount of that derivative, subject to a narrow range of reductions as further set

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<sup>3</sup> The same request was made in the Basel FAQ Submission at p. 1.

<sup>4</sup> The same request was made in the Basel FAQ Submission at p. 5.

forth in the proposal. This measure of exposure is considerably more stringent than the measure applied to other types of derivatives.

Despite some claims to the contrary, the existence of a liquid and active market in credit derivatives provides many benefits to the US economy. The decline in CDS trading volumes has coincided with a reduction in corporate lending by banks and a reduction in international capital flows.<sup>5</sup> Credit default swaps are a critical risk management tool for commercial entities, insurance companies, pension funds, asset managers and banks. In addition, the CDS market provides a transparent indicator of the health of the credit markets on both a macro and micro scale. A recent academic study has shown that the credit default swap market can lower the cost of corporate borrowing because it makes monitoring a borrower's credit easier.<sup>6</sup>

For the reasons set forth below, the Associations believe the Proposed Rule should be modified to (A) recognize reductions to the new measure of exposure for a broader range of offsetting positions that plainly reduce actual economic exposure; and (B) clarify that this more stringent exposure measure does not apply to written credit derivatives cleared for clients through CCPs.

#### **A. Recognition of a Broader Range of Risk-Reducing Hedges**

The Proposed Rule permits banks to offset the effective notional amount of written credit derivatives by the effective notional amount of credit derivatives purchased as long as the following conditions are met:

- The written and purchased credit derivatives reference the same legal entity;
- The reference exposure of a purchased single name credit derivative ranks *pari passu* or is more junior to the reference exposure of the written credit derivative; and
- The maturity of the purchased credit derivative is equal to or greater than the written credit derivative.

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<sup>5</sup> The Financial Times and McKinsey report that cross-border capital flows are almost 70 percent below the pre-crisis peak. Ralph Atkins & Keith Fray, *Capital Flows: Powered Down: Cross-Border Funding Is Far Below its 2007 Peak, but with Uncertain Effect*, Financial Times, January 6, 2014, available at <http://www.ft.com/intl/cms/s/0/efcb6f4c-7209-11e3-bff7-00144feabdc0.html?siteedition=intl#slide0>. Federal Reserve data show that commercial and industrial lending only regained its pre-crisis peak level late in 2013. See Federal Reserve Bank of St. Louis, Economic Data, *Commercial and Industrial Loans, All Commercial Banks*, January 1, 1947 to April 1, 2014, available at <http://research.stlouisfed.org/fred2/series/BUSLOANS/>. In the meantime, according to DTCC, the gross notional of CDS outstanding has fallen by approximately 40 percent from November 2008 to May 2014. See DTCC, Trade Information Warehouse Reports, Section I: Open Positions Data, available at <http://www.dtcc.com/repository-otc-data.aspx>.

<sup>6</sup> Ivanov, Ivan, Joao Santos, Thu Vo. "The Transformation of Banking: Tying Loan Interest Rates to Borrowers' CDS Spreads." *Simon School Working paper* No. FR 13-25.

In addition, other conditions apply to the offsetting of tranching credit derivatives:

- The purchased credit derivative must cover all of the written credit derivatives' reference exposures;
- The reference exposures of the purchased credit derivative must be *pari passu* to the reference exposures of the written credit derivative; and
- The seniority of the purchased credit derivative must be *pari passu* to the written credit derivative.

The Associations believe that this extremely narrow approach to offsetting positions would result in the substantial overstatement of actual economic exposure, even under severely stressed conditions. We therefore respectfully request the Agencies to modify the Proposed Rule with a more measured but conservative approach that would result in a more realistic measure of actual economic exposure. While this approach would diverge to some extent from the approach taken in the 2014 BCBS revisions, we believe this different approach is fully warranted, for two reasons. First, as previously noted, the different approach would result in a much more realistic measure of actual economic exposure than the measure adopted in the Proposed Rule, and measuring actual economic exposure is the fundamental purpose of the denominator of the supplementary leverage ratio.

Second, the more stringent measure for credit derivatives than for derivatives generally, disproportionately affects the very largest firms that are also subject to the enhanced supplementary leverage ratio, because these are the same firms that are most heavily engaged in the credit derivatives business. Since the enhanced supplementary leverage ratio is a higher, U.S.-only requirement, the Agencies have considerably more leeway to diverge from the Basel leverage ratio with respect to specific requirements that apply primarily or exclusively to those firms subject to the higher U.S.-only leverage ratio.

Accordingly, the Associations request the following adjustments to the Proposed Rule to expand the recognition of hedges to sold credit protection.

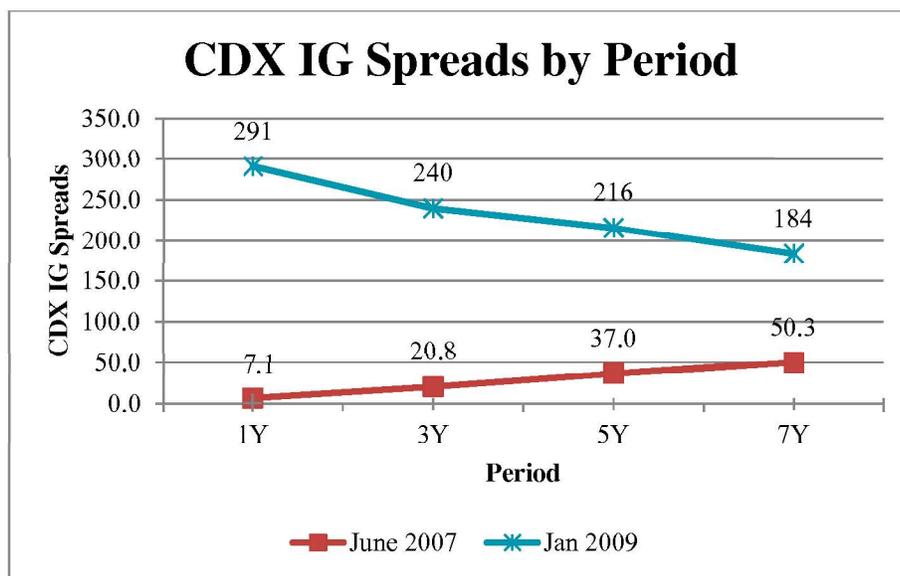
**1. A forward maturity mismatch should not immediately disqualify the hedge**

The requirement that the purchased CDS have a maturity equal to or greater than the sold CDS is overly punitive, particularly in the context of market-making portfolios. Like any market, the single name CDS market exhibits seasonality and cycles of supply and demand. In their role as market-makers, banks will buy and sell protection in response to customer demand. It is exceedingly rare for two investors to want to buy and sell protection on the same name in precisely the same tenor at precisely the same time. For the market to remain healthy, banks have to manage the residual risk.

For example, a portion of the return that sellers of protection hope to realize comes from the fact that credit curves are naturally upward-sloping since long-term credit

protection is typically more expensive than short-term credit protection. This so-called “roll down” benefits sellers because even in the absence of market moves, the value of a CDS contract falls as it ages. On the other hand, many investors that purchase protection will “roll” the protection each quarter to the most liquid “on the run” point on the curve, which is typically the five-year period, to maximize liquidity. Because sellers typically age their positions while buyers typically roll their positions each quarter, market structure and dynamics inherently create 3 month mismatches 4.75 years into the future.

In the severely adverse case of a liquidity crisis, credit curves tend to flatten or invert rather than steepen. For example, and as shown below, in June of 2007 CDS curves were upward sloping, as they typically are. The 5-year CDX index traded 16 basis points wider than the 3-year version of the same contract (37 vs. 21). However, by January 2009, the relationship had reversed – the 5yr point was 24 basis points tighter (216 vs 240). The Proposed Rule would incent banks to create structural steepener positions (owning protection that is longer dated than sold protection) that will perform poorly in a stressed environment, thereby increasing systemic risk.



Furthermore, the proposed rule presumes that banks can hedge on a one-for-one basis, but that is not always feasible in a market-making capacity.

Consider the following two trades:

1. A pension fund client buys 5 year protection on IBM from Bank A so that the pension fund can mitigate its credit risk on an IBM bond it holds. Bank A therefore sells protection for 5 years.
2. An insurance company client bought 5 year protection on the same IBM bond a year ago from Bank B to hedge the insurance company’s bond holding. They sold the bond six months later. Having sold the bond, the insurance company is now short the risk through the credit protection it purchased. Terminating that

position early might be expensive for the insurance company, so it instead hedges its now 4.5 year CDS protection by selling 4.5 year CDS to Bank A. Bank A therefore buys protection for 4.5 years.

Under these circumstances, Bank A has a half-year mismatch, which comes due in 4.5 years. Although Bank A has almost 5 years to mitigate the forward risk, the 4.5 year purchased protection is not recognized in the total leverage exposure, even though it is an effective economic hedge for that 4.5 year period. The Proposed Rule proposes to treat the 4.5 year forward exposure as if it is an unhedged current exposure even though the bank is hedged today.

We appreciate the Agencies' concerns that banks will be unhedged for some time period if the written credit protection has a maturity greater than the purchased credit derivative. However, this concern is most warranted for mismatches that create exposure in the very near term, whereas for long-term mismatches banks have adequate time to hedge the resulting mismatch. We therefore believe that it is appropriate to differentiate between short-term and long-term rollover risks in order to avoid substantially overstating the actual economic exposure.

Accordingly, the Associations propose that the Proposed Rule be modified so that purchased credit protection that has a residual tenor which is sufficiently long-term be considered an eligible hedge if all of the other netting criteria are met. This simple and straightforward change would still be conservative since short-term hedges would continue to be disallowed. The definition of "long term" could be made consistent with the regulatory capital framework or other prudential initiatives, such as:

- The Basel 3 credit risk mitigation framework, which provides partial hedge recognition if the hedge has an original maturity over 1 year and a residual maturity of at least 3 months;
- The Net Stable Funding Ratio (NSFR), which requires financing through "long term" debt that has a maturity of at least 1 year; and
- The annual CCAR stress period, which lasts for a period of nine quarters.

By not recognizing the hedge as described above, the Proposed Rule would divorce the SLR from prudent risk management. It would therefore create the perverse incentive for an institution to enter into new transactions in order to gain hedge recognition under the SLR, while actually increasing economic risk. In contrast, if the Proposed Rule were modified to recognize the hedge, it would ensure that the SLR is aligned with prudent risk management, aligned with actual economic exposure, and avoids creating perverse incentives that will increase systemic risk.

## **2. Treatment of CDS tranches**

The BCBS 2014 revisions and the Proposed Rule each rely on an exposure methodology which recognizes credit protection purchased as an effective hedge to credit protection sold only where the remaining maturity of the protection purchased is equal to or

greater than the remaining maturity of the protection sold and subject to further requirements related to the underlying reference exposure and subordination. For protection sold on a subset of a pool of reference entities, such as a tranche on an index, the BCBS 2014 revisions provide that protection purchased on the same pool of reference entities may offset the sold protection, “provided the purchased protection covers the entirety of the subset of the pool on which protection has been sold.”<sup>7</sup> We understand that these criteria are designed to ensure that hedge recognition is only available where two positions are substantively identical as a matter of economic reality.

The preamble to the Proposed Rule, however, imposes a further limitation on hedge recognition for tranche positions on a pool of reference entities that goes beyond the BCBS 2014 revisions:

To reduce the effective notional principal amount of sold credit protection that references multiple exposures, the reference exposures of the purchased credit protection would need to refer to the same legal entities and rank *pari passu* with the reference exposures of the sold credit protection. In addition, the level of seniority of the purchased credit protection would need to rank *pari passu* to the level of seniority of the sold credit protection. *Therefore, offsetting would be recognized only when all of the reference exposures and the level of subordination of protection sold and protection purchased are identical.* For example, a banking organization may reduce the effective notional principal amount of the sold credit protection on an index (e.g., the CDX), or a tranche of an index, with purchased credit protection on such index, or a tranche of equal seniority of such index, respectively.<sup>8</sup>

The italicized text does not include the “subset” proviso from the Basel 2014 revisions quoted previously (“provided the purchased protection covers the entirety of the subset of the pool on which protection has been sold.”). We believe that this removal of the “subset” proviso in the Proposed Rule’s preamble creates an additional limitation in the Proposed Rule and conflicts with the principle of recognizing hedges where two positions are substantively identical as a matter of economic reality. We therefore recommend, as described in more detail below, that the final rule modifying the denominator to the SLR and eSLR (the “Final Rule”) recognize any hedge where credit protection purchased covers the entirety of the subset of the credit protection sold.

Specifically, we believe that modifications to the Proposed Rule are justified in three situations: (a) where purchased protection positions cover all sold protection positions, but the attachment and detachment points differ (“Full Coverage”); (b) where purchased protection positions cover a subset of sold protection positions (“Subset Coverage”); and (c) where

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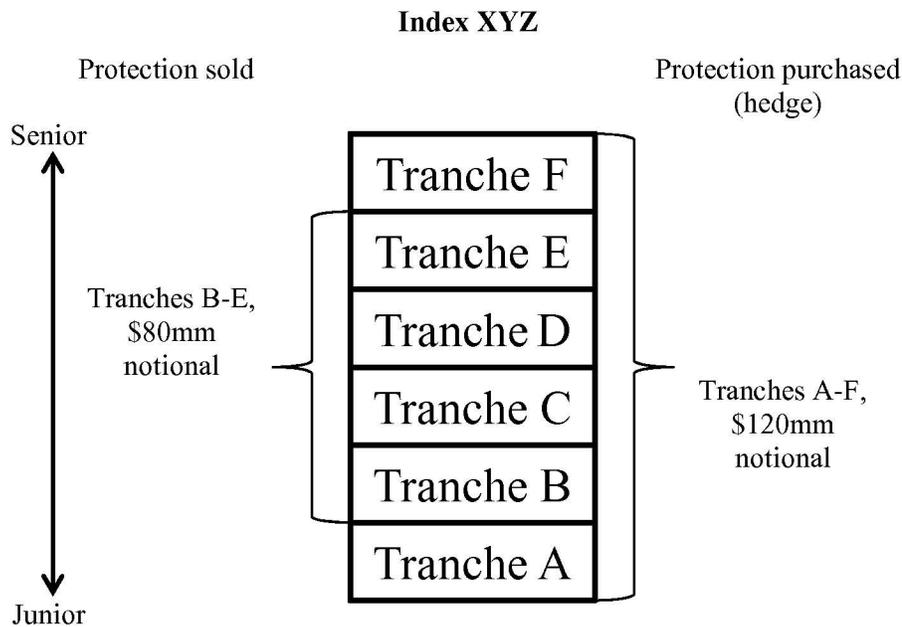
<sup>7</sup> BCBS 2014 revisions ¶ 30 & n. 14.

<sup>8</sup> 79 Fed. Reg. 24,596, 24,600 (May 1, 2014) (emphasis added).

purchased protection positions are in the same securitization vehicle as sold protection positions, but the purchased protection positions cover more junior tranches in the securitization structure (“Junior Coverage”). Together, the suggested modifications better reflect prudent risk management and the economic substance of existing hedges without compromising the Agencies’ conservative approach to the measure of total leverage exposure under the SLR/eSLR.

**a) Full Coverage**

By way of illustration, consider a banking organization that has sold and purchased credit protection referencing the same index:



In this structure, assume that each tranche has a width of \$20 million. The banking organization has sold credit protection on Tranches B-E, for a total notional amount of \$80 million, while purchasing credit protection on Tranches A-F, for a total notional amount of \$120 million. For Tranches B-E, the reference exposures and the level of subordination of protection sold and protection purchased are identical. Although the bank has purchased an additional layer of credit protection for Tranches A and F, these additional layers do not affect the economic symmetry of the positions covering Tranches B-E. If losses were to occur, the banking organization would receive credit protection payments up to \$20 million but no more on Tranche A, following which the bank would make and receive equal, offsetting credit protection payments for any losses in Tranches B-E. If losses extended into Tranche F, the bank would receive payments up to \$20 million. In this example, Tranches A-F represent the entire securitization structure, but the same principles would apply regardless of whether the banking organization purchased protection on the entire structure or on a subset of tranches that is broader than the tranches on which it sold protection.

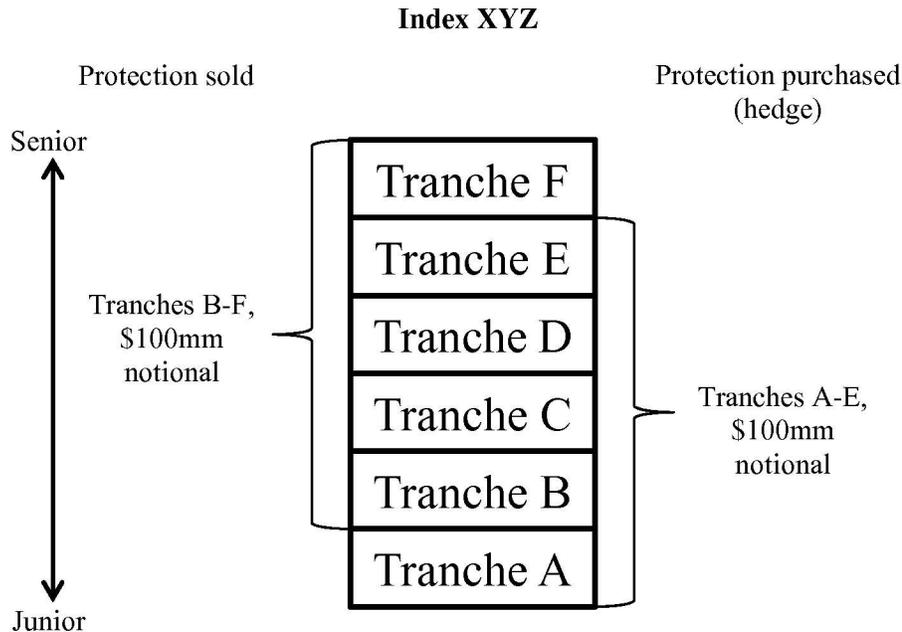
As a matter of economic reality, the protection purchased for Tranches B-E is an effective hedge to the protection sold on Tranches B-E, even though the attachment and detachment points on the purchased credit protection and sold credit protection are not identical. Stated another way, where a banking organization buys credit protection on each tranche of an entire securitization structure, but sells credit protection on only a portion of tranches within the securitization structure, the protection purchased on the entire structure should be deemed an effective hedge against the credit protection sold, since the relevant “subsets” within the securitization structure involve offsetting purchased and sold protection.

We believe that the BCBS 2014 revisions would recognize the Tranches B-E hedge protection in the above example as exposure-reducing because the purchased protection covers the entirety of the subset of the sold protection. Such recognition is consistent with both footnote 14 in the BCBS 2014 revisions, which recognizes hedges “provided the purchased protection covers the entirety of the subset of the pool on which protection has been sold,” and footnote 16, which requires that, “for tranching products, the purchased protection must be on a reference obligation with the same level of seniority.” However, we are concerned that the Proposed Rule would *not* recognize the “subset” hedge, as the protection sold and purchased have different attachment and detachment points.

Accordingly, we recommend that the Agencies clarify in the Final Rule that banking organizations would be permitted to recognize, with respect to securitization or other tiered structures, purchased protection as a hedge to sold protection to the extent the purchased protection covers the entirety of the subset of the pool on which protection has been sold. Such a clarification would be entirely consistent with the BCBS 2014 revisions.

**b) Subset Coverage**

It may also be the case that the banking organization has purchased and sold protection on the same reference index where there are common overlapping tranches, but where the purchased protection does not cover the entirety of the subset of the sold protection. Consider the following example:



Again, assume that each tranche has a width of \$20 million. In this structure, the banking organization has sold credit protection on Tranches B-F, for a total notional amount of \$100 million, while purchasing credit protection on Tranches A-E, again for a total notional amount of \$100 million. For Tranches B-E, the reference exposures and the level of subordination of protection sold and protection purchased are identical. Although the bank has purchased an additional layer of credit protection for Tranche A, and sold an additional layer of credit protection for Tranche F, these additional positions do not affect the economic symmetry of the positions covering Tranches B-E. If losses were to occur, the banking organization would receive credit protection payments up to \$20 million but no more on Tranche A, following which the bank would make and receive equal, offsetting credit protection payments for any losses in Tranches B-E. If losses extended into Tranche F, the bank would make payments up to \$20 million without offsetting protection. As a matter of economic reality, the protection purchased for Tranches B-E is an effective hedge to the protection sold on Tranches B-E, even though the attachment and detachment points on the purchased credit protection and sold credit protection are not identical. Finally, as in the prior example, hedge recognition in this case would be consistent with footnote 16 in the BCBS 2014 revisions since the protection purchased covers positions at the same level of seniority as the sold protection.

Failure to recognize hedging in these circumstances may incentivize banks to enter into new transactions in order to gain hedge recognition under the SLR. In the above example, the bank has unhedged economic risk to both Tranches A and F. If the overlapping subset of the purchased protection position cannot be recognized as a hedge of the corresponding sold protection position, a bank may be compelled to purchase protection on Tranches B-F in order to hedge the sold protection for the SLR exposure measure. However, while the SLR exposure would be reduced to zero, the bank is left with unhedged purchased protection risk to Tranches A-E, whereas the bank was only exposed to Tranches A and F prior to entering into the

new transaction. In order to hedge the now unhedged risk to Tranches A-E, the bank may now be incented to enter into another transaction, the result of which would be to increase derivatives notional, and thereby increase systemic risk, solely in order to improve hedge recognition under the SLR.

Another example of how a bank may be incentivized to meet the requirements of the Proposed Rule would be to split the original sold and purchased transactions into the following:

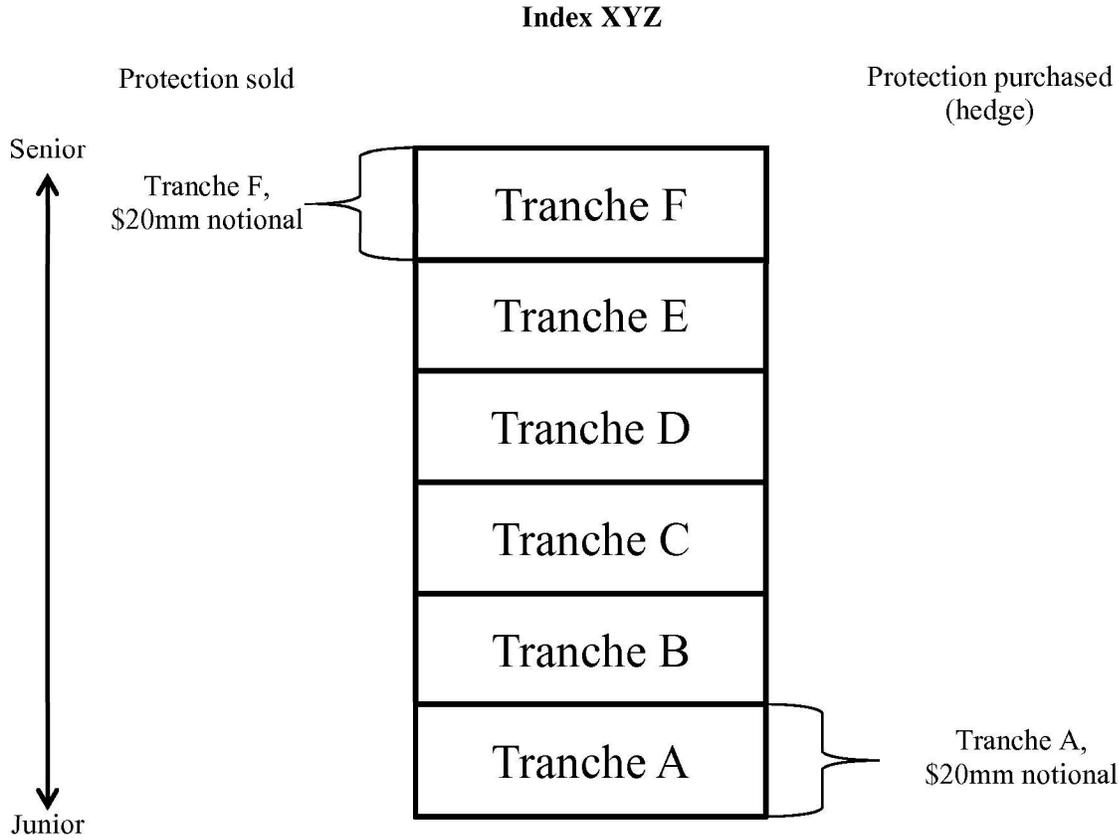
- Sold protection of \$80 million on Tranches B-E and sold protection of \$20 million on Tranche F
- Purchase protection of \$80 million on Tranches B-E and purchased protection of \$20 million on Tranche A

In this scenario, the Proposed Rule would recognize the hedge of the sold protection on Tranches B-E and the bank's remaining exposure on Tranche F would be unhedged. The economic reality of the transactions would be no different than the original two trades in the example above, albeit at higher transaction volume and cost, incurred solely to meet the requirements of the Proposed Rule.

Therefore, in addition to clarifying that banking organizations would be permitted to recognize, with respect to securitization or other tiered structures, purchased protection as a hedge to sold protection to the extent the purchased protection covers the entirety of the subset of the pool on which protection has been sold, we further recommend that purchased protection should be recognized as a hedge to sold protection to the extent of common protection, even if the purchased protection does not cover the entirety of the subset of the sold protection. We believe that failure to incorporate this recommendation into the final leverage framework will result in unintended outcomes in the marketplace. Banking organizations would be prevented from recognizing hedges where, in economic reality, a subset of a purchased protection position hedges a subset of a sold protection position. In addition, market participants would expend considerable energy to re-document existing positions or enter into additional transactions to conform with the technical requirements of the Proposed Rule, even though such efforts would not change the economic substance of existing hedges or otherwise protect banking organizations from market or credit risk, and would needlessly introduce operational risk.

**c) Junior Coverage**

Finally, in some cases a banking organization may purchase credit protection on a junior position in a securitization tranche while selling protection on a more senior position. This scenario is illustrated in the following example:



In this scenario, the credit protection purchased on Tranche A is an effective hedge to the credit protection sold on Tranche F, since Tranches A-E would have to suffer losses before the banking organization would be required to make payments on the Tranche F protection. In any loss scenario, the banking organization would receive full payment on the Tranche A protection purchased before being required to make any payments on the Tranche F protection sold.

The BCBS 2014 revisions appear to offer a conflicted view on hedge recognition in this example. As a general matter, the Basel text recognizes an effective hedge where “the credit protection purchased is on a reference obligation which ranks *pari passu* with *or is junior* to the underlying reference obligation of the written credit derivative in the case of single name

credit derivatives.”<sup>9</sup> In principle, this approach would lead to recognition of Tranche A protection purchased as an effective hedge to Tranche F protection sold, since Tranche A protection purchased is junior to the Tranche F protection sold and would always pay out before the payment obligation on the more senior position is triggered. However, Footnote 16 clarifies that, “for tranching products, the purchased protection must be on a reference obligation with the same level of seniority.”<sup>10</sup>

The BCBS did not provide its rationale for the footnote language quoted above. We assume, however, that the BCBS was concerned about the reliability of junior tranche protection as a hedge to more senior positions; in the above example, perhaps the concern was that Tranche F would suffer a loss before the banking organization would be able to receive the protection on Tranche A. This concern could be addressed through other requirements for junior protection, such as a requirement that hedge recognition only be recognized where more junior protection purchased would always pay out before the senior protection obligation is triggered.

We believe that there is no economically significant difference between credit protection purchased on a more junior bond (with the protection hedging protection sold on a more senior bond) versus credit protection purchased on a more junior securitization tranche (with the protection hedging protection sold on a more senior tranche). In each case, the reason that the hedge is effective is that the banking organization’s purchased protection will be triggered before its payment obligation is triggered. To the extent that there is concern about the reliability of junior hedge triggers, this could be addressed through requirements in hedge recognition criteria, as suggested in the preceding paragraph. Accordingly, we ask the Agencies to consider recognizing protection purchased on junior tranches as an effective hedge, either directly in the Final Rule by following the general principles in the BCBS 2014 revisions as opposed to the footnote, or by engaging in discussions with the BCBS to revise or eliminate Footnote 16.

## **B. Treatment of Sold Client-Cleared Credit Protection Provided through CCPs**

The Proposed Rule should clarify that, for purposes of a banking organization’s total leverage exposure, sold credit protection cleared on behalf of a client through a CCP should not be measured at the effective notional amount, but should instead be measured in the same manner as derivatives generally. This clarification would be consistent with the text of the BCBS 2014 revisions to the Basel III leverage ratio, which provides that a performance guarantee in the context of a client-cleared transaction should be measured by reference to only the specific provisions of that document generally applicable to derivatives, with no reference to the specific provisions applicable to written credit derivatives.<sup>11</sup>

In addition to the textual rationale summarized above, we also note that the underlying logic and structure of the SLR should result in excluding client-cleared credit

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<sup>9</sup> BCBS 2014 revisions, ¶ 30 (emphasis added).

<sup>10</sup> BCBS 2014 revisions, FN 16.

<sup>11</sup> BCBS 2014 revisions, ¶ 28, at 5.

protection from the notional exposure measurement. The SLR measures written credit protection on an effective notional basis, not on a notional basis. The SLR recognizes that credit protection sold can be hedged by offsetting credit protection purchased, resulting in no effective notional protection sold. This is true in the case of a banking organization's own exposures, such as when the banking organization sells credit protection to one counterparty and buys offsetting credit protection as a hedge from another counterparty, and equally true when the bank facilitates client clearing activity. In the latter case, the banking organization, when acting as a clearing member, stands in between the customer and the CCP. While the banking organization has credit risk to its customer in the event of customer default, the banking organization is market risk neutral on the cleared credit derivative, since any change in the market position of the contract will be covered by daily variation margin calls on the customer. Accordingly, client-cleared written credit derivatives are like any other class of client-cleared products: the banking organization itself is market risk-neutral and its credit exposure to its customer should be covered by margin requirements in the same way as with any other asset class.

Finally, the Associations believe that such a clarification would be fully consistent with the Agencies' and international regulators' broader macroprudential support of initiatives designed to increase the volume of centrally cleared derivatives. CCPs are subject to rigorous regulatory oversight that requires member banks to adhere to strict by-laws that cover initial margin, variation margin, and default fund contributions, thus reducing the need to include cleared CDS in the total leverage exposure measure at the effective notional amount.

Accordingly, the Associations strongly support the proposed clarification that would measure sold credit protection provided to clients that is cleared through CCPs consistently with the measurement of derivatives generally; this would better reflect the reduced level of actual exposure for such derivatives and enhance support for central clearing.

### **III. Repo-Style Transactions**

Under the Proposed Rule, the gross value of receivables associated with repo-style transactions is included in the total leverage exposure, unless offsetting contracts with a counterparty meet the following three eligibility criteria:

1. The offsetting transactions have the same explicit final settlement date under their governing agreements;
2. The right to offset the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable in the normal course of business and in the event of receivership, insolvency, liquidation, or similar proceeding; and
3. Under the governing agreements, the counterparties intend to settle net, settle simultaneously, or settle according to a process that is the functional equivalent of net settlement. That is, the cash flows of the transaction are equivalent, in effect, to a single net amount on the settlement date. To achieve this result, both transactions must be settled through the same settlement system and the settlement arrangements must be supported by cash or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day, and the

settlement of the underlying securities does not interfere with the net cash settlement.<sup>12</sup>

The Associations believe that, consistent with the goal of reflecting actual economic exposure, the three conditions in the Proposed Rule should be clarified as set forth below.

**A. Interpretation of Same Final Settlement Date in First Condition**

With respect to the first condition for netting, the Proposed Rule should be modified to clarify that undated repo-style transactions (including “open” or “evergreen” repos, which can be unwound unconditionally at any time by either counterparty), may be treated as having a one-day maturity for purposes of the requirement that cash payables and cash receivables may be measured net only if they have the same “explicit final settlement date.”<sup>13</sup> Undated repo-style transactions are market practice in certain countries, but are functionally equivalent to an overnight repo-style transaction with a one-day maturity that is rolled over every day. Treating undated repo-style transactions that can be unconditionally unwound by either party, as described above, as having a one-day maturity would permit an institution to net cash payables and cash receivables from the same counterparty in connection with such instruments. Absent this clarification, the measure of total leverage exposure would apply inconsistently based on local market practice, despite the economic equivalence of the underlying instruments.

**B. Clarification of Third Condition that “settlement of the underlying securities does not interfere with the net cash settlement”**

The third condition provides that the counterparties must intend to settle net, settle simultaneously, or settle according to a process that is the functional equivalent of net settlement. The Proposed Rule provides that this condition is not met unless “settlement of the underlying securities does not interfere with the net cash settlement.”<sup>14</sup> The purpose of this language is very unclear. A failure to deliver securities on one transaction would result in a change to the amount of cash that is net settled on other transactions, but we do not believe this constitutes “interference” since the intention is to settle the cash legs on an effective net settlement basis. Any failure in the settlement process would be subsequently addressed, but to reflect positions on a gross basis, on the assumption that all associated securities settlements will fail, is unreasonable and does not reflect the high level of effective securities settlements made. We are concerned that inclusion of the language could lead to confusion, and we therefore recommend its deletion in the Final Rule.

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<sup>12</sup> 79 Fed. Reg. at 24,601 (col. 3).

<sup>13</sup> The same request was made in the Basel FAQ Submission at p. 7.

<sup>14</sup> 79 Fed. Reg. at 24,601 (col. 3).

**C. Recognition of Offsetting in Security-for-Security Repo-Style Transactions where the Bank Includes the Securities on its Balance Sheet**

Under the Proposed Rule, a banking organization may reduce total leverage exposure by the value of securities received in security-for-security repo-style transactions, where the bank acts as a securities lender and includes the securities received in its on-balance sheet assets but has not sold or re-hypothecated the securities received. If the securities lender sells or re-hypothecates the security, the securities lender would include the amount of cash received or, in the case of re-hypothecation, the value of the security pledged as collateral in total leverage exposure. The Proposed Rule is designed to achieve a consistent treatment of security-for-security repo-style transactions under different accounting frameworks.

However, this approach does not neutralize the difference in accounting frameworks in the case where a securities lender re-hypothecates a security received under a security-for-security transaction. The following examples illustrate the resulting accounting-driven difference if re-hypothecated securities are not excluded from the total leverage exposure:

1. If the security received in a security-for-security transaction is re-hypothecated and pledged under a repo-style transaction where the bank receives cash, the cash received would be included in the bank's on-balance sheet assets. Thus, the requirement to include the pledged security results in a double-count in the exposure measure because both the security received in the security-for-security transaction and the cash received in the subsequent repo transaction would be included in total leverage exposure. Under an accounting framework that does not require on-balance sheet recognition of the securities received in security-for-security transactions, only the cash would be included in total leverage exposure.
2. If the security received in a security-for-security transaction is re-hypothecated and pledged under another security-for-security transaction where the bank is acting as a security lender, the security received in the second security-for-security transaction will be included in the bank's on-balance sheet assets. If the security received in the second transaction is also re-hypothecated, then the Proposed Rule would require that the securities received under both of the security-for-security transactions be included in total leverage exposure. Under an accounting framework that does not require on-balance sheet recognition of the securities received in security-for-security transactions, neither of these securities would be included in total leverage exposure.

Accordingly, if the intention is to achieve consistency for the treatment of security-for-security transactions despite differing accounting frameworks, the Proposed Rule should be modified to permit a bank to reduce total leverage exposure by the value of securities received in security-for-security repo-style transactions, where the bank acts as a securities lender and includes the securities received in its on-balance sheet assets. The further requirement that the Bank has not sold or re-hypothecated the securities received should be removed.

## IV. Credit Conversion Factors (“CCFs”) for Off-Balance Sheet Exposures

### A. CCFs Applicable to Forward-Starting Repo-Style Transactions

In calculating its total leverage exposure measure under the Proposed Rule, a banking institution would be required to apply a variable CCF to its off-balance sheet exposures.<sup>15</sup> The applicable CCF for off-balance sheet exposures would vary, consistent with the BCBS 2014 revisions, between ten percent and 100 percent based on the characteristics of the exposure (for example, an unconditionally cancellable exposure would be subject to a ten percent CCF, while a commitment with an original maturity of one year or less that is not unconditionally cancelable would receive a 20 percent CCF).

Although the use of a variable CCF will more accurately reflect the risks associated with off-balance sheet exposures, such treatment could result in a significant overstatement of a banking institution’s off-balance sheet exposures with respect to forward-starting reverse repos and securities borrowing transactions<sup>16</sup> that have been entered into at an agreed rate but have not yet been settled.

In many cases, a forward-starting repo-style transaction is intended to replace an existing repo transaction that appears on a banking organization’s balance sheet at trade date, but matures and rolls off the balance sheet on the settlement date of the forward-starting repo-style transaction. In effect, this practice creates a single synthetic instrument with an extended maturity period.

A vast majority of repo/reverse repo transactions settle T+0 (*i.e.*, on the trade date), T+1, T+2 or T+3. For trades that do not settle T+0, repos/reverse repos do not appear on the balance sheet on trade date. Rather, such positions are reflected on the balance sheet on the settlement date. Between the trade and settlement dates, the accounting treatment for such positions varies. That is, if the settlement period is standard,<sup>17</sup> forward-starting repos are usually treated as “commitments.” In this context, two different accounting treatments may apply:

- A bank may use the fair value option (FVO) if the transaction is determined to be a firm commitment, in which case the mark-to-market value<sup>18</sup> associated with the

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<sup>15</sup> 79 Fed. Reg. 24,602 (col. 3).

<sup>16</sup> Such treatment would only apply to reverse repos or securities borrowing transactions that are viewed as commitments, and not to repos or securities lending transactions.

<sup>17</sup> If the settlement period is longer than market standard for the associated securities, some firms may account for the forward-starting repo as a derivative (at fair value). However, it is unusual for forward-starting repos to meet the definition of a derivative, and the associated derivative exposures (if any) are typically very minimal for banks. Any such forward-starting repos booked as derivatives would receive the derivative treatment set forth in the leverage ratio standard.

<sup>18</sup> In this context, mark-to-market value reflects changes in the funding rate between the trade date and the settlement date.

unfunded transaction (rather than the full notional value) is reflected on the balance sheet between trade date and settlement date; or

- If the FVO is not used, the forward-starting repo is treated as entirely off-balance sheet until the settlement date.

In this context, it is unclear how the Proposed Rule would treat forward-starting repo-style transactions for purposes of calculating total leverage exposure. If such transactions are viewed as “commitments” or as “forward asset purchases,” then a 20-100 percent conversion factor of the notional amount would apply. The resulting capital charge, however, would in many cases double count the exposures already on the balance sheet that already receive securities financing transactions treatment and are about to roll over.

We believe the text should be clarified in the Final Rule to avoid these adverse consequences. Specifically, an appropriate clarification would be to apply the repo counterparty credit risk add-on only (measured as  $\max(0, \sum E_i - \sum C_i)$  where a qualifying master netting agreement is in place, or  $\max(0, E_i - C_i)$  where no such qualifying agreement is in place). This treatment would be fully consistent with paragraph 33(ii) of the BCBS 2014 revisions, and it should be roughly equivalent for the two accounting treatments (FVO or non-FVO). While those under FVO would also get a charge for their on-balance sheet exposure, sometimes they would be in the money and other times they would be out of the money; on balance this amount would tend toward zero.

## **B. Treatment of Deliverable Bond Futures and OTC Equity Forward Purchases**

Similarly, the Associations believe that the Proposed Rule should be clarified so that deliverable bond futures are not treated as the type of off-balance sheet exposures that are subject to CCFs. Bond futures are frequently used to hedge trade exposures, are extremely liquid, and are central to the liquidity of many government bond markets. They are typically rolled over approaching maturity. For accounting purposes, bond futures are treated as derivatives in the trading book, and we believe similar treatment would be appropriate for purposes of total leverage exposure, rather than being treated as off-balance sheet items. Likewise, we believe that OTC equity forward purchases in the trading book should be captured as a derivative exposure, not an off-balance sheet exposure subject to the CCF.<sup>19</sup>

## **C. Treatment of Forward Forward Deposits**

The Proposed Rule should clarify that so-called “forward forward deposits” that represent the renewal of an existing deposit upon maturity should not be treated as an off-balance sheet exposure subject to a CCF. A forward forward deposits, in which an institution commits to accept a deposit in the future for a fixed period of time, commonly represents the renewal (before maturity) of an existing deposit. While such instruments create additional credit risk for an institution by effectively extending the maturity of an existing deposit, they do not typically increase leverage. As a result, inclusion of a forward forward deposit as an off-balance sheet

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<sup>19</sup> For both of these issues, the same request was made in the Basel FAQ Submission at pp. 9-10.

exposure subject to the CCF would result in double-counting for purposes of determining the institution's total leverage exposure. Therefore, the Proposed Rule should be clarified to exclude forward deposits that represent the renewal of an existing deposit on its maturity (whether with an existing counterparty or a new counterparty).<sup>20</sup>

## V. Daily Averaging of Exposures

The Proposed Rule would revise the manner of calculating a banking institution's total leverage exposure: instead of calculating the arithmetic mean of such exposure as of the last day of each month in the reporting quarter, a banking institution would be required to calculate "the arithmetic mean of the total leverage exposure calculated for each day of the reporting quarter."<sup>21</sup> The Proposed Rule specifically requests comment on the "operational burden and integrity" of applying the daily averaging approach *only* for on-balance sheet assets, and using the quarter-end calculation methodology for off-balance sheet exposures, in computing total leverage exposure.<sup>22</sup> As described below, the Associations believe that such an approach would be an appropriate "alternative method" of calculating the total leverage exposure.<sup>23</sup>

The proposed revision to the calculation of total leverage exposure for *on-balance sheet assets* would appropriately address concerns with end-of-month fluctuations that effect on-balance sheet assets. As recognized in the preamble to the Proposed Rule, the calculation of on-balance sheet assets using the average of three month-end balances could result in an inflated total leverage exposure for a banking institution that experienced sudden substantial deposit inflows at the end of reporting periods or during times of financial stress.<sup>24</sup> The daily averaging of on-balance sheet assets will help normalize on-balance sheet assets that may fluctuate over the course of the reporting period.

There are, however, significant practical and cost issues associated with the daily averaging of *off-balance sheet* exposures, and such a requirement is not necessary to address relevant policy concerns. As a result, the Associations request that the Proposed Rule be modified in the manner described below.

### A. Calculation of Off-Balance Sheet Exposures on a Quarter-End Basis

Typically, banking institutions do not calculate off-balance sheet exposure amounts on a daily basis. Therefore, requiring the daily calculation of such exposures would require the industry to implement broad changes to reporting systems.

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<sup>20</sup> The same request was made in the Basel FAQ Submission at p. 10.

<sup>21</sup> 79 Fed. Reg. at 24,603 (col. 3), 24,604 (col. 1).

<sup>22</sup> *Id.* at 24,604 (col. 1).

<sup>23</sup> *See Id.*

<sup>24</sup> *Id.*

Finally, while one general policy reason for averaging in other contexts has been to prevent end-of-period manipulation or “window dressing” that can occur with point-in-time calculations, that concern would not be present with the type of off-balance sheet exposures captured in total leverage exposure. For example, there would be little or no ability to manipulate at a point in time the unused portion of a loan commitment or the value of a standby letter of credit in order to reduce an exposure amount.

In sum, the Proposed Rule should be modified to permit a banking institution to calculate its total leverage exposure for a quarterly reporting period based on the daily average of on-balance sheet assets, and the quarter-end balance or month-end balance average of off-balance sheet exposures. In short, the Final Rule should adopt the alternative methodology noted in Question 17 of the Proposed Rule.<sup>25</sup>

**B. If Daily Averaging is Required for Off-Balance Sheet Exposures, Need for Longer Implementation Period**

Under the Proposed Rule, many banking institutions will be required to report their supplementary leverage ratios beginning on January 1, 2015.<sup>26</sup> As previously discussed, the requirement to calculate total leverage exposure on a daily basis, especially for off-balance-sheet exposures, would result in significant operational and systems challenges for reporting institutions. Therefore, if the Agencies decide to require the daily averaging of off-balance sheet exposures — and we do not believe there is reason to do so — then substantially more time should be provided to institutions to implement the very significant systems changes that would be required.

**VI. Required Disclosures Should Include Associated Entities Not Subject to Regulatory Consolidation**

The Proposed Rule would require institutions to disclose information “to summarize the differences between the total consolidated accounting assets reported on a banking organization’s published financial statements and regulatory reports and the calculation of total leverage exposure.”<sup>27</sup> While the Associations support the goal to require banking institutions to disclose information “in a comparable and consistent manner,” *id.*, the disclosure table at Part 1, line 2, could be read to exclude associated entities reflected on an institution’s balance sheet on the basis of proportionate consolidation. The exclusion of such entities would result in a lack of comparability among institutions that are subject to the accounting rules for proportionate consolidation, and thus would result in a lack of comparability among reporting institutions. Such a result would be at odds with the stated intent of the disclosure tables.

Accordingly, Part 1, line 2 of the disclosure table should be revised to require institutions to list “investments in banking, financial, insurance or commercial entities that are

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<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 24,606 (col. 3).

<sup>27</sup> *Id.* at 24,604 (col. 3).

consolidated for accounting purposes on the basis of proportionate consolidation, including those entities that are outside the scope of regulatory consolidation.” Such a clarification would further the Proposed Rule’s stated goal of improving comparability and consistency among the disclosures of reporting institutions.<sup>28</sup>

## **VII. Treatment of Cash in Total Leverage Exposure**

The inclusion of cash in the total leverage exposure could very well cause the SLR/eSLR requirement to become the binding capital constraint, rather than the risk-based capital requirement. This would be especially likely during times of financial market stress when banking organizations receive significant inflows of cash due to factors outside of their immediate control. Excluding cash, which is plainly riskless, from the total leverage exposure would preserve the long-standing “backstop” role that the leverage ratio has played with respect to the risk-based capital requirement.

Banking organizations have experienced significant inflows of cash during periods of financial market stress, including in the days following the collapse of Lehman Brothers in late 2008 and the U.S. debt ceiling crisis of late 2011. A number of factors drive these cash inflows. Among the most significant is the liquidation of investment positions as investors reassess their view of the financial markets and adjust their investment allocations. Investors then place the resulting cash on deposit with their bank, increasing the bank’s balance sheet. Recognizing that these are sudden, temporary increases in deposit balances, banking organizations place these deposits in very liquid assets as part of a sound liquidity risk management strategy. Depending upon the banking organization’s business model, these cash inflows may be placed with a bank affiliate or with a national central bank, notably the FRB. Such “flight to cash” inflows are not driven by efforts to increase a banking organization’s economic exposure and, indeed, are caused by factors entirely outside the organization’s control.

This inflow of cash caused few concerns in the past since historically, most banking organizations have been capital-constrained by the risk-based capital framework, which assigns a zero percent risk-weight to cash deposits held by the banking organization. This zero percent risk-weight is appropriate because cash does not generate the type of risk of loss that capital is intended to offset. Indeed, cash is, by definition, the most liquid, riskless asset. This is acknowledged by the BCBS, which categorizes cash as a Level 1 asset for purposes of the Basel III Liquidity Coverage Ratio. As a result of the zero percent risk weight, a banking organization receiving large inflows of cash deposits would see no change in its risk-based capital ratios (assuming all other elements of its assets, off-balance sheet activities, and liabilities remain constant). At the same time, the separate 4 percent U.S. Tier 1 leverage ratio requirement, which applies only to on-balance sheet assets, acts as an appropriate “backstop” to ensure that banking organizations hold enough capital against total assets, including cash.

In its current design, however, the calibration of the SLR/eSLR would penalize banking organizations that receive large inflows of cash deposits, because such deposits would be included, dollar-for-dollar, in total leverage exposure. In extreme cases, where depositors

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<sup>28</sup> The same request was made in the Basel FAQ Submission at p. 8.

move large sums of cash or liquidate substantial portions of their investment portfolios, the increase in cash could materially weaken the SLR/eSLR at the banking organization receiving the cash. This decrease in the SLR/eSLR could result in substantial adverse consequences, such as dividend and other capital restrictions and negative market signals. Banking organizations could even be forced to turn away new customers or reject deposits from existing customers to avoid further expanding their balance sheets.

Accordingly, the Associations recommend that the Agencies consider appropriate solutions to mitigate the impact of these “flight to cash” concerns. It would be simplest and most straightforward to exclude cash entirely from total leverage exposure because cash simply does not increase leverage in the financial system. Moreover, the capital framework should complement the liquidity framework, which requires banking organizations to hold robust liquidity reserves, especially cash, which are most relevant during periods of financial market stress.

We recognize that we have made similar arguments to the Agencies in the past, and we appreciate the careful consideration that the Agencies gave to these concerns. We also recognize that limiting the amount of central bank deposits could conflict with the leverage ratio as a simple measure that does not distinguish among asset classes and is not risk-sensitive. In view, however, of the potential adverse implications of a leverage ratio that serves as the binding regulatory capital constraint, especially in periods of financial market stress, we believe that it is important to reiterate our concerns and recommended solution — especially in light of the fact that the 4 percent on-balance sheet U.S. leverage ratio would still act as a backstop to the risk-based capital requirement.<sup>29</sup> While the Associations believe that a complete exclusion of cash from total leverage exposure would be the best way forward, we would also support alternative remedies, such as a partial exclusion or limit on the amount of cash included in total leverage exposure.

If, despite this request, the Agencies should choose not to accept a cash exclusion, they should at a minimum affirm in the Final Rule their statutory authority to exercise discretion when addressing temporary breaches of minimum leverage ratio requirements due to surges in banking organizations’ cash. For example, if a banking organization temporarily failed for this reason to satisfy the “well capitalized” requirement for prompt corrective action purposes, an agency could choose not to impose dividend or other capital restrictions. Similar flexibility would apply to other regulatory sanctions that would result from such a temporary decline in minimum leverage ratios, including a bank holding company’s qualification as a financial holding company.

The fundamental point is that a banking organization should not be punished for a decline in its leverage ratio resulting from a temporary surge in cash that does not materially increase the bank’s actual economic exposure — especially because the bank would be helping

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<sup>29</sup> In the preamble to the final eSLR rule, the Agencies expressed concern that exclusion of cash from that requirement would remove limits on the ability of banking organizations to fund cash assets entirely with debt. 79 Fed. Reg. at 24,536 (col. 2) (May 1, 2014). However, the residual 4 percent U.S. leverage ratio would preclude such a result.

to promote the stability of financial markets and client demand for a “safe haven.” Just as the Agencies recognize that the Basel III Liquidity Coverage Ratio may be breached during periods of financial market stress, they should acknowledge the potential for a similar occurrence in leverage ratio requirements and provide for a reasonable and proportionate regulatory response.

### **VIII. Treatment of U.S. Treasury Securities in Total Leverage Exposure**

The Proposed Rule applies to large U.S. banking organizations, many of whom have broker-dealer subsidiaries that act as primary dealers in U.S. Treasury securities. Primary dealers serve a vital market function in U.S. government finance, facilitating the U.S. Treasury’s ability to access capital markets efficiently and cheaply. The volume of U.S. Treasury securities held by any primary dealer will vary from quarter to quarter in response to trends in U.S. government finance and market conditions, but at the end of 2013 the eight U.S. banking organizations subject to the eSLR collectively held almost \$295 billion in U.S. Treasury securities, much of which was concentrated in their primary dealer subsidiaries.

As it does with respect to cash, the U.S. risk-based capital requirement assigns a zero percent risk-weight to U.S. Treasury securities.<sup>30</sup> In other words, the risk-based capital regime does not require U.S. banking organizations to hold capital against the risk of U.S. government default, consistent with the Basel framework (although banking organizations hold capital against the market risk of U.S. treasury securities under the Agencies’ market risk rule). U.S. banking organizations are, however, effectively subject to limits on their holdings of U.S. Treasury securities — just as they are with respect to cash — through the long-standing U.S. on-balance sheet leverage ratio,<sup>31</sup> which was recently increased from three to four percent of on-balance sheet assets.<sup>32</sup> In combination, while the risk-based capital standards permit U.S. banking organizations to maintain large inventories of U.S. Treasury securities to support U.S. government capital markets activities, the balance sheet leverage ratio imposes an absolute backstop on the size of banking organizations’ balance sheets, including with respect to holdings of U.S. Treasury securities.

The Proposed Rules would modify, and potentially destabilize, this long-standing balance of risk-based and balance sheet leverage ratio requirements that has facilitated the U.S. Treasury’s capital markets activities for decades. In many cases, the binding or nearly binding capital constraint for large U.S. banking organizations will no longer be the risk-based capital standards or the U.S. on-balance sheet leverage ratio, but will instead be the SLR/eSLR, which imposes the same capital requirement on all asset classes, from low-risk U.S. Treasury securities to high-risk products. These banking organizations may be compelled to adjust internal capital allocations to business lines, including their primary dealer subsidiaries, taking into account the relative returns of business line activities rather than their relative risk profiles. As banking organizations adjust their business models in response to these pressures, there could be follow-on effects in the capital markets, including in the pricing and liquidity of U.S. Treasury

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<sup>30</sup> U.S. Basel III Rules §\_32(a)(1)(i)(A).

<sup>31</sup> See U.S. Basel III Rules §\_.10(a)(4) (imposing a 4 percent balance sheet ratio on U.S. banking organizations).

<sup>32</sup> *Id.*, 78 Fed. Reg. 62,018, 62,170 (October 11, 2013).

securities. Furthermore, the inclusion of U.S. Treasury securities in total leverage exposure may lead to greater reluctance by banking organizations to participate in any future sales of U.S. Treasuries by the Federal Reserve, or to engage in overnight repurchase agreement transactions, both of which could impact the tools used by the Federal Reserve to implement monetary policy.

We believe that the long-standing combination of risk-based and U.S. balance sheet leverage ratio requirements provides an appropriate capital framework for large banking organizations' holdings of U.S. Treasury securities. Accordingly, we request that the Agencies consider removing banking organizations' holdings of U.S. Treasury securities from total leverage exposure. Such an exclusion would support the U.S. Treasury's access to capital markets, thereby helping to maintaining low public borrowing costs, while the 4 percent on-balance sheet U.S. leverage ratio would continue to impose a backstop on the size of banking organizations' overall balance sheets.<sup>33</sup> While the Basel III leverage ratio does not contain an exclusion for U.S. Treasury securities, we believe that such an exclusion from total leverage exposure would be appropriate in the SLR/eSLR in light of the unique credit risk profile of the U.S. Treasury (as compared to sovereigns generally), the higher U.S.-only standard of five percent for the largest institutions subject to the eSLR, and the U.S.-only 4 percent backstop leverage ratio for on-balance sheet assets.

#### **IX. Exclusion from Total Leverage Exposure of Segregated Cash Collateral from Clients**

The Associations believe that it would be appropriate for the Final Rule to exclude cash from total leverage exposure, as described above in Part VII. In the event the Agencies decline to adopt a complete exclusion for cash, however, we believe the Final Rule should at least exclude segregated cash for cleared derivatives transactions ("segregated cash") from the total leverage exposure.

Under the Proposed Rule, a banking organization must follow prescribed calculation methodologies to determine its on-balance sheet assets and off-balance sheet exposure, both of which factor into the calculation of the banking organization's total leverage exposure. To calculate the on-balance sheet component of the total leverage exposure, the Proposed Rule would require a banking organization to include the full amount of its on-balance sheet assets, reduced only by certain amounts deducted from tier 1 capital under the Agencies' regulatory capital rules.<sup>34</sup> Although this approach may be appropriate for many categories of on-balance sheet assets, the factors discussed below support the exclusion from total leverage exposure of segregated cash, notwithstanding its accounting treatment as an on-balance sheet asset under U.S. GAAP.

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<sup>33</sup> We note that new capital and liquidity regulation is projected to have material impacts on the pricing and liquidity of transactions supported by U.S. Treasury securities. See, e.g., Goldman Sachs Equity Research, "As regulation shifts to leverage & liquidity, short-term financing markets may get squeezed," May 4, 2014, p. 4 (analyzing the impact on reverse repurchase agreement pricing spreads under the SLR).

<sup>34</sup> See 79 Fed. Reg. at 24,598 (col. 2-3).

When an entity within a banking organization acts as a futures commission merchant clearing member of a CCP (“clearing member”) and clears a cleared derivatives transaction on behalf of a client, initial margin is posted in the form of cash or securities collateral. The amount of such initial margin that is required by the CCP will be passed on to the CCP. Any excess required by the clearing member is retained by that clearing member and is subject to customer asset protection rules enforced by the Commodity Futures Trading Commission (“CFTC”) and other prudential regulators. Any cash posted by a client to meet its initial margin obligation is generally reflected as an on-balance sheet asset of the clearing member, regardless of whether the cash is passed on to the CCP to meet its requirements or is retained by the clearing member; in both cases, the cash remains as an asset in the customer segregated pool. In contrast, any securities collateral posted by the client to meet its initial margin obligations is *not* treated as an asset of the clearing member; instead, such securities collateral is reflected only on the balance sheet of the client.

Under the customer asset protection rules issued by the CFTC, the clearing member may not use any segregated cash posted by the client to support the clearing member’s own operations. Instead, such client cash must be used to satisfy the obligations of the client at the CCP, with any excess segregated cash deposited or invested by the clearing member according to the CFTC’s customer asset protection rules. Moreover, such deposited or invested excess cash must remain in the client segregated pool.

In contrast with such derivatives transactions cleared through CCPs, when an entity within a banking organization transacts in the over-the-counter derivatives market, any cash margin collected or up-front premium received can be re-used by that banking organization for its daily operations. That is, the banking organization may lend that cash in exchange for securities or use the cash to purchase assets for its own portfolio. That is not the case with initial cash margin and excess cash margin received by a clearing member from a client in support of cleared derivatives activity. As previously described, such segregated cash collected for cleared transactions cannot be used to support the operations of the clearing member because the cash is legally segregated from the clearing member and is subject to the customer asset protection rules. In essence, such segregated cash really constitutes an asset of the client, not the clearing member. As a result, we believe that such segregated cash should be excluded from total leverage exposure.

Set forth below are both legal and policy reasons that flesh out and support this proposed exclusion.

**A. Segregated Cash Is Not Treated as a Bank-Owned Asset in Bankruptcy.**

Generally, cash owned by a banking organization is available to pay claims of creditors during the bankruptcy process, just like other unsecured assets owned by the bank and held on its balance sheet. Segregated cash held by a clearing member, however, is exempt from this general treatment. *See, e.g.*, 11 U.S.C. § 766. Such treatment under fundamental bankruptcy principles is further evidence that segregated cash held for a client is really the client’s asset, not the banking organization’s, and therefore should be excluded from total leverage exposure.

**B. CFTC Rules Strictly Limit the Ability to Reuse or Re-Hypothecate Segregated Cash.**

Pursuant to CFTC rules, a clearing member may only invest segregated cash in a narrow range of financial instruments. *See* 17 C.F.R. § 1.25. These instruments include only safe and conservative investments (for example, obligations of the United States that are fully guaranteed as to principal and interest). The investment of segregated cash must be managed “with the objectives of preserving principal and maintaining liquidity. . . .” *Id.* § 1.25(b). Thus, a clearing member may not use segregated cash to fund its own operations or re-lend it to increase the banking organization’s leverage. These investments are meant to increase the yield on excess client balances held by the clearing member, part of which may be remitted to the client.

Accordingly, the CFTC’s rigorous limits on the ability of a clearing member to reuse or re-hypothecate segregated cash reinforces the conclusion that such assets belong to the customer, not the clearing member, and do not increase the banking organization’s leverage or actual economic exposure.

**C. Excluding Segregated Cash Would Incentivize Prudent Risk Management and Avoid Unintended Consequences.**

The Proposed Rule could unintentionally result in greater systemic risk by both (1) creating strong incentives for clearing members to require clients to post securities as collateral, rather than cash, and (2) incenting such organizations to limit the amount of excess segregated cash a client should post, even though such excess cash benefits the clearing member and reduces systemic risk.

*First*, the Proposed Rule would incentivize clearing members to require clients to post securities, rather than cash, as collateral for derivatives transactions. U.S. accounting rules generally treat segregated cash held for clients significantly differently from segregated securities collateral held for clients, even though both mitigate risk associated with derivatives transactions. Specifically, segregated cash is generally treated as an on-balance sheet asset of a banking organization under U.S. GAAP, while segregated securities collateral is not. Because of this differential treatment of cash and securities, the Proposed Rule would penalize a clearing member for holding segregated cash by inflating the banking organization’s total leverage exposure by the amount of such cash, while holding securities collateral would have no impact on the banking organization’s total leverage exposure.

Such a stiff leverage capital penalty for holding segregated cash would create a powerful incentive for a clearing member to require clients to post collateral in the form of securities rather than cash – even though securities collateral presents greater risks to the organization. Unlike segregated cash, securities collateral is subject to price fluctuations and liquidity risk that may reduce the protection to the clearing member (even in light of any haircut required to the value of securities collateral), and over the long-term will require more frequent collateral calls. Both of these consequences increase risk to the clearing member and, when those risks are aggregated across the industry, to the financial system. Moreover, requiring the posting of securities rather than cash would significantly increase burden for clients: the costs

associated with pledging securities as collateral are significantly greater than those associated with posting cash.

*Second*, the Proposed Rule would create a strong disincentive for clearing members to require clients to post *excess* segregated cash, even though such excess cash would reduce risk to the institution and to the financial system as a whole. For example, consider the simple example of a derivatives contract cleared through a clearing member under which its client has \$1 of exposure to loss.

- *Scenario A:* In this scenario, the client posts \$1 in segregated cash, the minimum amount required by the clearing member to cover its current risk. Under the Proposed Rule, the banking organization would have an additional \$1 of on-balance sheet assets included in its total leverage exposure, but would be exposed to counterparty risk if the derivative declined in value.
- *Scenario B:* In this scenario, the client posts \$10 of segregated cash with the clearing member, which is well in excess of the client's (and the clearing member's) current exposure to loss. As a result, the clearing member would have additional protection from loss if the value of the derivative declined, but the full value of that *reduction* in risk would be treated as an *increase* in risk through its inclusion in the banking organization's total leverage exposure under the Proposed Rule.

This problematic treatment of excess segregated cash is no mere hypothetical problem, because clearing members often require excess cash as a prudent risk management practice. As a result, the Proposed Rule would create a powerful and perverse incentive for clearing members *not* to require the posting of excess segregated cash — a result that would be plainly at odds with the fundamental risk-reducing purpose of the leverage ratio.

#### **D. Exclusion of Segregated Cash Would Be Consistent with the Treatment of Segregated Cash Under the Liquidity Coverage Ratio.**

Finally, under the proposed U.S. liquidity coverage ratio, segregated cash would not qualify as a high-quality liquid asset. Specifically, the proposed liquidity coverage ratio rules provide that high quality liquid assets must be “free of legal, regulatory, contractual, or other restrictions on the ability of the [clearing member] to monetize the asset.”<sup>35</sup> The exclusion of segregated cash from the scope of “high-quality liquid assets” reflects the inability of a clearing member to use segregated cash to meet its liquidity needs.

The proposed liquidity coverage ratio rules recognize that segregated cash cannot be treated as an asset available to meet a banking organization's liquidity needs, even though cash is typically an optimal asset for providing liquidity. Similarly, a clearing member may not use segregated cash to increase leverage, due to the “legal, regulatory, [and] contractual” restrictions on the ability of such a clearing member to use such assets for its own purposes.

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<sup>35</sup> Prop. 12 C.F.R. § \_\_.20(e)(1)(i), 78 Fed. Reg. 71,818, 71,861 (November 29, 2013).

Thus, the exclusion of segregated cash from the measurement of a banking organization’s total leverage exposure would be consistent with the treatment of segregated cash under the proposed liquidity coverage ratio rules — which in turn is consistent with the basic concept that segregated cash for a client really does not belong to the clearing member, does not fund the clearing member’s operations, and ought not be treated as an “exposure” of the banking organization.

#### **X. Future Treatment of the Standardized Approach for Measuring Counterparty Credit Risk Exposures (“SA-CCR”)**

In adopting the BCBS 2014 revisions, the BCBS noted that the Basel III leverage ratio:

makes reference to the Current Exposure Method (CEM) which is used under the Basel II framework to calculate CCR exposure amounts associated with derivative exposures. The Committee is considering alternatives to the CEM. If an alternative approach is adopted as a replacement for the CEM, the Committee will consider whether that alternative approach is appropriate in the context of the need to capture both types of exposures created by derivatives<sup>36</sup>

Following publication of the BCBS 2014 revisions, the BCBS issued the SA-CCR in March 2014. In so doing, the BCBS stated that SA-CCR “will replace both current non-internal models approaches, the Current Exposure Method (CEM) and the Standardised Method (SM).”<sup>37</sup> As a result, the BCBS will soon consider whether to replace CEM with SA-CCR in the Basel leverage ratio.

The Associations believe that the BCBS should indeed proceed to replace CEM with an appropriate version of SA-CCR, and that the Agencies should support that effort. The methodological weaknesses of CEM are well recognized, which the BCBS summarized when it issued the SA-CCR standard.<sup>38</sup> To address these weaknesses in the SA-CCR, the Basel Committee’s “main objectives were to devise an approach that is suitable to be applied to a wide variety of derivatives transactions (margined and unmargined, as well as bilateral and cleared); is capable of being implemented simply and easily; addresses known deficiencies of the CEM and the SM; draws on prudential approaches already available in the Basel framework; minimizes discretion used by national authorities and banks; and improves the risk sensitivity of the capital

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<sup>36</sup> *Id.*, p. 3, n. 5.

<sup>37</sup> Basel Committee on Banking Supervision, *The standardised approach for measuring counterparty credit risk exposures* (March 2014, rev. April 2014), p. 1.

<sup>38</sup> “The CEM had been criticized for several limitations, in particular that it did not differentiate between margined and unmargined transactions, that the supervisory add-on factor did not sufficiently capture the level of volatilities as observed over recent stress periods, and the recognition of netting benefits was too simplistic and not reflective of economically meaningful relationships between derivatives positions.” *Id.*

framework without creating undue complexity.”<sup>39</sup> These objectives in developing SA-CCR as a replacement for CEM are just as important in the context of the Basel III leverage ratio as they are in the context of risk-based capital requirements.

Assuming the BCBS will act to incorporate SA-CCR into the Basel III leverage ratio in an appropriate manner, the Associations believe that the Agencies should ultimately incorporate a similar version of SA-CCR in the SLR/eSLR. In this context, we believe the Agencies should make clear in the preamble to the Final Rule regarding the calculation of total leverage exposure that they will consider the replacement of CEM with SA-CCR once the BCBS has addressed this issue. The CEM is plainly outdated as a measure of actual economic exposure, and its ultimate replacement with an improved measure of such exposure, as SA-CCR is intended to provide, would significantly strengthen the SLR/eSLR.

Providing this guidance is important because U.S. banking organizations must make decisions today about how to manage their businesses over a long-term time horizon in which the SLR is likely to be the binding capital constraint. If the Agencies clarify in the Final Rule their intention to ultimately incorporate SA-CCR into the SLR, banking organizations will be better able to make long-term capital allocation decisions, more clearly disclose to the marketplace their long-term business strategies, and otherwise avoid disruptions and inefficiencies that arise from uncertainty in a major component of the regulatory capital framework.

If the Agencies believe that there remains uncertainty as to whether the BCBS will formally incorporate SA-CCR into the Basel leverage ratio, we believe that, at a minimum, the Agencies should clarify in their Final Rule that they intend to align the SLR with further changes made by the BCBS to its leverage ratio, including when the Basel Committee clarifies its intention to incorporate SA-CCR into the Basel III leverage ratio.

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<sup>39</sup> *Id.*

The Associations thank the Agencies for considering the comments and recommendations set forth in this letter. If you have any questions or need further information, please do not hesitate to contact:

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Respectfully submitted,



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