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Leverage ratio threat to the cleared derivatives ecosystem

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Sir, Regarding Thomas M Hoenig's article "Weakening leverage ratio undermines banks' accounting" (FT Trading Room, FT.com, August 12): while we respect Mr Hoenig's views regarding the value of the Basel Committee's leverage ratio, we believe there are flaws in its application to cleared derivatives. These flaws threaten to undermine the global efforts to bring more derivatives into central clearing, damage the health of the clearing ecosystem, and make it more difficult for investment managers, commodity producers and other customers to hedge their risks.

The leverage ratio is designed to require banks to hold capital against actual exposures to loss, yet the current construct fails to consider existing market regulations that mitigate such losses. Unlike making loans or taking deposits, guaranteeing client trades exposes the bank to losses only to the extent that the margin collected is insufficient to cover the clients' clearing obligations. To make sure that margin is available to absorb losses, it is posted in the form of either cash or extremely safe and liquid securities such as US Treasuries. Furthermore, there are strictly enforced rules to ensure that client margin is available for the limited purpose of guaranteeing the customers' trades and is therefore segregated away from the bank's own money. Given these longstanding regulatory requirements, it stands to reason that the leverage ratio should recognise segregated client margin as reducing the bank's actual economic exposure.

As a factual matter, we respectfully disagree with the view that recognising customer margin in the leverage ratio calculation would be "completely contrary to accounting standards and basic accounting principles". The recently revised leverage ratio captures exposures that by definition are not recognised by or subject to accounting rules. The inclusion of these off-balance sheet exposures in the leverage ratio is entirely a regulatory construct and in this context it is certainly appropriate for segregated client margin to be recognised as exposure-reducing.

We are concerned that left unchanged the leverage ratio will undermine recent financial regulatory reforms by driving banks out of the clearing business, thereby reducing access to clearing and limiting hedging opportunities for end users. This harms farmers seeking to manage commodity price fluctuations, commercial companies wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. The negative impacts to the real economy are significant and we strongly encourage the Basel Committee to avoid these risks by revising the leverage ratio to accurately reflect the treatment of client margin in the cleared derivatives markets.

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