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FRENCH BANKING FEDERATION POSITION PAPER ON DELEGATED ACT ON THE LEVERAGE RATIO IN EUROPE – MARCH 2014

Introduced in the Basel 3 framework as a backstop to the solvency ratio, the leverage ratio is defined in Europe by Article 429 of the CRR. This text was adopted by the European parliament before the Basel Committee for Banking Supervision (BCBS) publication of the final rules for the ratio's calculus, which have been disclosed only in January 2014.

So, the two texts are not aligned and differ on various provisions:

- Off balance sheet exposures conversion mechanism;
- Derivatives exposure, netting and currencies 'collateral considerations;
- Securities financing transactions, criteria and levels of netting;
- Written credit derivatives.

The commission services have required the feedback of the stakeholders on these divergences, and more specifically, on the netting of Securities Financing Transactions "SFTs", on the treatment of cash variations margins for derivatives exposure and on the criteria for allowing the notional amount of written CDS to be reduced with the protection recognition.

The French Banking Federation (FBF) is pleased to submit its views on these different issues.

This paper is divided into two parts. In *the first part* the FBF makes some general comments on the will of the Commission to align the CRR leverage ratio exposure measure with the Basel III leverage ratio exposure measure. In *the second part* the FBF answers to the questions raised by the European Commission (EC) in its stakeholder paper, especially with regards to the treatment of SFTs, written credit derivatives and derivatives collateral.

1. Part I : General comments with regards to the considered alignment of the CRR with the Basel III Leverage ratio exposure measure

1.1 Process on amending the calculation of the ratio at this stage while the observation period is not completed

The CRR states that the LR is a new regulatory and supervisory tool for the European Union. In line with international agreements it should - as a first step - be introduced as an additional feature that can be applied on individual institutions at the discretion of supervisory authorities. Reporting obligations for institutions would allow appropriate review and calibration with a view to migrate the LR to a binding measure in 2018 (Recital 94). In addition, **Article 511 introduces an observation period to gather sufficient data for the implementation of a binding leverage ratio under Pillar I in Europe.**

The observation period is set out as follows:

- Reporting requirement via the national authorities to the EBA on the basis of a common template as of 1 January 2014. For this purpose, the EBA adopted in July 2013 a common template by means of an implementing technical standard (ITS);
- According to Article 14 of this ITS, a quarterly reporting for the LR was established. Therefore, the first reporting reference date was 31 March 2014. **However, the ITS has extended this reference date to 30 June 2014;**
- Public disclosure as of 1 January 2015;
- Finally, the EC should report by **31 December 2016** to the EP and Council on the appropriateness to introduce in Europe a mandatory leverage ratio by 2018 via a legislative act.

Article 456 (1) (j) CRR states that the "*EC will be empowered to adopt a delegated act concerning the amendment of the capital measure and the total exposure measure of the leverage ratio referred to in Article 429 (2) {Calculation of the leverage ratio} **in order to correct any shortcomings** discovered on the basis of the reporting referred to in Article 430 (1) before the leverage ratio has to be published by institutions as set out in Article 451 (1)(a)*".

Under the above-mentioned article of the CCR (delegated act), the EC has the power without a specific calendar to amend the definition of capital measure (numerator) and the total exposure measure (denominator) of the LR to correct **any shortcoming on the basis of the reporting requirements**[1] for the observation period ending in 2016 but before the disclosure by 1 January 2015 (Article 521 a).

Legally speaking the CRR empowers the EC to amend the LR calculation **if the reporting requirements** show **shortcomings**. Against this legal approach the first reporting would be completed only in June 2014 via a common standard elaborated by EBA. Therefore, if the EC aims to adopt a delegated act to transpose the recent Basel III framework, the reporting will not be completed before the envisaged date (June 2014).

[1] Article 430

The absence of consistent data on the impact of January BCBS framework is clearly shown by the recent EBA own initiative report on the impact of differences in the leverage ratio definitions[2]. The EBA report based its analysis on data gathered for Basel III monitoring up to June 2013 recognizing that "*The CRR definition of the leverage ratio and the Basel III definition have not yet been tested through a quantitative impact study (QIS), which implies that the corresponding estimations are based on a number of simplifying assumptions as the available data did not always allow for an assessment with full precision*".

Despite this lack of quantitative impact assessment, the EBA recommends the alignment of the CRR to the Basel III in terms of definition of LR for the benefit of a consistent LR calculation within the EU and the other jurisdictions.

Finally, it is worth to note that the EBA is claiming that the CRR would offer different interpretations of the treatment of the Securities Financing Transactions leading to a discrepancy in the level of the LR, and hence they would support a full alignment with the Basel III framework whereas flexibility on the interpretation of the exposure measure responds under the EU legislation to the main objective of the observation period and the CRR aims to **test a ratio** as requirement under Pillar II.

Given the absence of consistent data on the impact of the latest BCBS framework regulators should carefully assess its European transposition in the Delegated Act by 30 June 2014. Indeed, flexibility on the interpretation of the exposure measure is needed as the observation period is precisely meant to give the EC the power and opportunity to amend the definition of the leverage ratio to correct any shortcoming on the basis of the reporting. This observation period should also be used to perform of a proper impact assessment of the January 2014 BCBS framework.

The FBF would welcome some changes to the Basel leverage ratio that could be assumed before analysing reporting evidence, without undue risk, such as:

- Calculation of the Leverage Ratio shall use end quarter numbers;
- Scope of consolidation shall be the regulatory scope of consolidation;
- Using the credit risk conversion factors for off-balance sheet exposures (0%, 20%, 50%, or 100% depending on the risk category), but subject to a floor of 10%.

1.2 SFTs netting criteria in the Basel framework do not portray adequately the exposures from SFTs, contrary to the CRR interpretation 1

The CRR differs substantially from final Basel 3 requirements on the criteria for netting SFTs negotiated with same counterparties within a master netting agreement framework.

[2] http://www.eba.europa.eu/-/eba-reports-on-impact-of-possible-leverage-ratio-definitions

The CRR basically recognizes the full effect of master netting agreement on credit risk (art 220), when Basel mimics accounting standards criteria, mixing IAS 32 and US GAAP FIN 41, to restrict netting when a so called net settlement effectively takes place.

There is no rationale for retaining the notion of net settlement in a calculus aimed to access a credit risk. This notion was developed first by the FASB, to accommodate the practice of netting in USA repos and reverse repos transactions, mainly operated through the Fedwire Securities Transfer System, with the criteria required by the accounting conceptual framework for netting payables and receivables[3]. Several criteria were listed to achieve characterizing a processing system as functionally equivalent to a genuine net settlement.

The BCBS has taken up most of these criteria listed in FIN 41, but also added some features from IAS 32 and a requirement of its own: to be considered as functional equivalent to an effective net settlement, settlement of all transactions must occur by the end of the business day and the linkages to collateral settlement do not result in unwinding net cash settlements, i.e. fails to deliver securities must not stop payments.

This last condition contradicts the very basic foundations of repos, delivery of securities versus payments.

We consider in these circumstances that **it is inappropriate to introduce the new Basel framework for SFTs netting**, as it does not capture adequately the effective credit risk from these transactions and it is unclear on the characterization of a net settlement functional equivalent system. Furthermore, it is centered on the US practice of overnight repos, mainly done through tri party repos, when the market practices in Europe are far different.

In its report on the leverage ratio, in the executive summary, EBA negates these differences or considers their impact as de minimis, without substantiating further its position later in the text.

EBA also states the Basel framework is a more accurate measure of leverage and that the treatment of the so called interpretation 2 of the CRR is the most prudent. None of these statements is supported by an argumentation or evidence.

As the leverage is defined as a ratio between Tier 1 capital and a modified total of assets, its value depends from the definitions of these two items. None of the possible definitions is more accurate than another in absolute terms. The question is: does it captures faithfully the solvency risk from another perspective than RWAs?

The answer is clear for SFTs netting: by mixing considerations of credit and liquidity risks, when trying to define a third set of netting criteria different from IFRS and US GAAP ones, Basel 3 framework is far less appropriate than Article 220 of the CRR for capturing the actual exposure of institutions resulting from SFTs.

[3] FIN 41 .9, basis for conclusions

Nevertheless, we recognize that Article 429. 5 and 9 of the CRR must be clarified. Paragraph 5 states that the leverage ratio is based on accounting exposures, whenever another methodology is not specified. Paragraph 9 introduces such methodology for SFTs, by allowing netting under various conditions stated in Articles 220, 222 and 206. Netting is retreatment of accounting entries, not a provision for taking into account a new risk not considered in accountancy. It is not an add-on mechanism, aiming to encompass for example, the future volatility of accounting figures. So, interpretation 1 must prevail: the net figures are a substitute for gross figures in the ratio calculus; interpretation 2 leads to a double counting of the transactions.

Though we think that Article 220, as it is the CRR, is far much appropriate for the objective of building a backstop to the solvency ratio, we want to highlight the deficiencies of the Basel 3 framework, especially in the European context. The example in **Appendix 1** illustrates our views on how calculate the SFTs exposure and how this additional exposure has to be incorporated in the accounting figures

1.3 This misrepresentation of SFTs may lead to detrimental effects on the pivotal role played by repo markets in the real economy financing

Repos are legally structured as sales of financial assets (mostly securities) combined with promises to repurchase those assets in the future. They are economically considered as collateralized loans.

The repo market is a **short term market**. Significant participants include primary dealers, central banks (in connection with their monetary policy), banks, insurance companies, industrial companies, mutual funds, pension funds and hedge funds, all benefiting from the operational efficiency, security and low funding costs offered in the repo market.

The **most commonly-used types of collaterals in the repo market are bonds issued by creditworthy central governments** that account for almost 80%[4] of European originated repo collateral. In the US, Treasury securities may account for about 2/3rd of that repo market, much of the rest being government-guaranteed Agency debt and Agency Mortgage-Backed Securities. The private sector assets form the smallest sector of the repo market.

Subject to a large range of regulations[5] and providing a secured source of funding, repo markets have widely grown up so as to become **crucial to the efficiency of capital markets.** Today, the European outstanding repo contracts is estimated to roughly 5,5 trillion euros[6] (at least 5 trillion USD for the US market). The importance of repo markets reflects the wide nature of its functions.

Repos are crucial for Primary dealership in both the primary and secondary securities market.

[4] International Capital Markets Association, FAQ Feb. 2013.

[5] Among which the EU Financial Collateral Directive, the Short Selling Regulation, the Capital Requirements Directive, the European Market Infrastructure Regulation (EMIR), the Market In Financial Instruments Directive (MiFID) and Regulations (MIFIR), the CSD Regulation, the Securities Law Directive and Crisis Management Directive, and the forthcoming regulation on reporting and transparency of securities financing transactions)

[6] International Capital Markets Association's semi-annual survey (Dec 2013). The survey includes the most active participants in the European repo market but is not comprehensive

In the *primary securities market*, Primary dealers are expected to contribute to economy financing by biding to Sovereign bond auctions or underwriting positions in syndicated bond issues. The repo framework allow Primary dealers to fund their bids at reduced cost and to hedge their underwriting risk, thereby providing **less risky and cheaper access to the capital markets for issuers - mostly Sovereigns**.

In the *secondary securities market*, Primary-dealers must stand continuously ready to purchase or sell securities and to quote buying and selling prices. However, Primary-dealers cannot afford to hold a large securities inventory that would substantially raise the cost of carry and **therefore the cost of debt to issuers**. To continuously quote buying prices, they rather rely on their ability to hedge accumulations of securities bought by lending these securities via the repo market. On the opposite, to quote continuously selling prices Primary-dealers do not necessarily hold a large inventory from which to sell on demand, they only need to make sure of their ability to deliver to the investor the securities they have sold 'short' if they are able to borrow that issue in the repo market.
Therefore, **repos provide liquidity in the debt market** by allowing Primary-dealers to finance an inventory of securities and to source those that are not in inventory in order to meet investor demand. Without the ability of doing so, Primary-dealers would be constrained to hold rigid and costly matched-books, raising the cost of debt to issuers and making debt securities less attractive.

More generally, repo is essential to the efficiency of financial markets

More generally, the collateralized nature of repo allows a wide range of lenders and borrowers to access to the wholesale money market, **creating a deeper, diversified and therefore more resilient market**, which in turn eases liquidity management and reduces systemic risk. Repos are used either to invest cash in a safe manner or to earn a return by lending out an asset.

Since collateralization secures the credit risks, **the repo market offers a cheap source of funding to borrowers of cash** (that are also in the same time lenders of securities), therefore lowering the financial cost to both investors and issuers. For lenders of cash (that are also in the same time borrowers of securities), 'reverse repo' transactions offer **a secured investment** because the buyer receives collateral to hedge the credit risk on the cash lent to the counterparty and can in turn use the collateral. On the sellers' side of the market, the principal users of repo are securities market intermediaries (broker-dealers) and investors such as hedge funds seeking funding. On the buyers' side, the principal users are cash-excess and risk-averse investors such as money market funds, seeking secured investments.

As for Central banks**,** the repo market provides an **efficient framework to implement monetary policy** by acting as lenders of last resort or removing liquidity from the financial system in times of stress.

The current Basel's Leverage ratio framework strongly penalizes SFTs activities

The **leverage ratio** is intended to be a *non-risk sensitive measure* of a bank's Tier one capital to its Exposure Measure. Originally thought as a 'backstop' measure to risk-based requirement, the current text makes it the **binding capital constraint.**

The Leverage ratio is especially penalizing for SFTs activities

By dismissing the possibility to take into account the collateral when calculating the leverage ratio exposure of repos, the final Basel's text of the **leverage ratio framework is considering repos transactions as unsecured loans**, which clearly disregards their real economic nature and therefore leaves banks with a **heavy and binding capital burden**.

Facing an additional heavy capital burden, banks may drop out of the repo business

From a bank's perspective, operating in the repo markets has historically been a low margin business. As a consequence, should the leverage ratio framework be applied as such, banks would face a new capital burden with regards to SFTs, and would be constraint to reassess their current business model leaving them with two options, (i) either invoice the additional costs (ii) or drop out these low margin but capital intensive business. By pressuring banks to reduce their repo businesses, as trading volumes are closely related to the outstanding amount of repos, it would severely **hinder banks' ability to intermediate, especially in the government securities markets**, leading to a quick liquidity dry-up in the repo markets, wider bid-offer spreads, increased price volatility and finally to a significant increase in the cost of debt to issuers, making debt securities less attractive. This could in turn have **severe consequences on financing for other repo market participants**.

2. Part II: answers to the questions raised by the EC in its stakeholder paper with regards to the treatment of SFTs, derivatives collateral and written credit derivatives

2.1 SFTs netting criteria: the Basel framework is unclear for SFTs on various requirements and, unsuited to European market practices

The Basel III Leverage Ratio framework should not be considered as completely stabilized because it still raises **many questions among the regulatory community and the industry**
(Cf. APPENDIX 2: GFMA-IIF Technical Recommendations sent to the BCBS on 17 March 2014).

Mainly 3 points related to SFTs raise concern:

- Repos: the condition of "same explicit final settlement date" (Point 33(i) a in BCBS 270)
- Repos: the "settlement" criteria (Point 33 (i) c in BCBS 270)
- SFTs: the condition for the exceptional treatment for a bank acting as agent (Points 36 & 37 in BCBS 270)

2.2.1 Netting of cash receivables from repos/reverse repos transactions with the same counterparty: the condition of "same explicit final settlement date" (Point 33(i)a in BCBS 270) needs to be adapted to the European open end repos

2.2.1.1 Fulfillment of Article 33(i)a in the BCBS 270 text

In Article 33, BCBS 270 text allows, in the leverage ratio exposure measure, the netting of repo and reverse repo cash receivables and payables, with the same counterparty under 3 conditions.

One condition is: "Transactions have the same explicit final settlement date".

Securities Financing Transactions do not always have an explicit final settlement date, as some of them are undated. This is the case of open or evergreen repos (in the EU), which are market practice in certain countries. In these cases, the transactions can be unwound unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day (US practice). We believe that these transactions should be treated as if they had a one-day maturity and that the requirement that they have the "same explicit final settlement date" should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The BCBS leverage framework would otherwise result in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos).

The condition in point 33(i)a in BCBS 270 should have been written as follows:
"Transactions have the same explicit final settlement date. Transactions with embedded call features «open» transactions are deemed as settling on a daily basis."

2.2.1.2 Proposal to amend Article 429 (9) in the CRR text

In CRR, June 2013, 429 (9) refers to allowing netting for SFTs in accordance with Article 220 (1) to (3) and Article 222 CRR, but without any detail regarding the netting of cash receivables from repos/reverse repos. If the **Delegated Act aims to mimic Basel 3, it should include a separate new paragraph in Article 429 (9) with the above amended BCBS 270 point 33(i) a.**

2.2.1.3 European specificities for the open end repos

An open repo (also known as *on demand* repo) is a repurchase agreement that is agreed without fixing the maturity date. Instead, the repo can be terminated on any day in the future by either party, provided they give notice before an agreed daily deadline. Until an open repo is terminated, it automatically rolls over each day. Interest accrues daily but is not compounded (i.e. interest is not earned each day on interest accrued over previous days). Outstanding interest is typically paid off every month.
The repo rate on an open transaction will be close to the overnight repo rate, but it will not change until the parties agree to re-set the rate. Open repo is used to invest cash or finance assets where the parties are not sure how long they will need to do so.

The US repo market is mainly overnight, **the maturity distribution of the European market is longer**.
According to the 26th repo market survey (as of 11 December 2013 position) in January 2014.International Capital Market Association (ICMA) and the European Repo Council (ERC) , on December 2013, the sum of repo and reverse repo outstanding (gross values of cash due to be repaid by you and repaid to you) is reaching EUR **5,499** billion. In Europe, the split by remaining term of maturity is as following:

- 6% repos are **open** end (of which more than 50% are tri-party transactions)
- 20% repos are **overnight** (term maturity 1 day)
- 9% repos are **forward-forward**
- 65% repos have a **term maturity >1 day**
  - 2 days to 1 week 16 %
  - 1 week to 1 month 22 %

>1 month to 3 months 17 %
>3 months to 6 months 5 %
>6 months to 12 months 3 %
>12 months 3%

Open repos share was 6% in December 2011, 13% in December 2012, 7% in June 2013 and 6% in December 2013.

In the leverage ratio BCBS 270 text, the requirement of "the same explicit final settlement date" for netting the cash legs generates an unlevel playing field for European repo market:
* European repos have more maturities to match vs US repos with mainly overnight maturity
*Some European repos are open end
That is why we believe that BCBS and CRR texts should treat open repos as overnight repos.

2.2.2 Netting of cash receivables from repos/reverse repos transactions with the same counterparty : The "settlement" criteria (Point 33 (i) c in BCBS) needs to be adapted to European settlement mechanisms specificities

2.2.2.1 Fulfillment of Article 33(i)c in the BCBS 270 text

In Article 33, BCBS 270 text allows, in the leverage ratio exposure measure, the netting of repo and reverse repo cash receivables and payables, with the same counterparty under 3 conditions.

One condition is: "The counterparties intend to **settle net, settle simultaneously**, or the transactions are subject to a settlement mechanism that results in the **functional equivalent of net settlement**, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date".
It is not clear what this condition means both in the European and US contexts. This criteria seems more aligned with the US 'tri-party repos framework, whereas for the European market tri-party repos only represent 10-12% of the market versus up to 66% in the US.

Nevertheless, the **European repo market is more diversified. We believe that the three types of settlement meet BCBS settlement criteria:**

- 10% tri-party repo (which is more secure than in the US as explained below))
- 30%-40% bilateral repos cleared through CCPs
- 50%-60% other bilateral repos mainly cleared through Euro-clear and Clear-stream and in delivery-versus-payment mechanism.

The BCBS leverage framework also refers to "linkages to collateral flows [that] do not result in the unwinding of net cash settlement**." We believe that this condition is intended to address that securities and cash should be settled on the same settlement system, which would be satisfied for most tri-party and bilateral SFTs**, though not cross currency repo (for example, hard currency exchange offshore, securities onshore would therefore not be eligible) .

The condition in point 33(i) c in BCBS 270 should have been written as follows:
"(c) The counterparties intend to settle net, **or** settle simultaneously or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount **at the end of** the settlement date. **This will occur if the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk.** To achieve such equivalence, both transactions are settled through the same settlement system, and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement**."**

2.2.2.2 Proposal to amend Article 429 (9) in the CRR text

In CRR, June 2013, 429 (9) refers to allowing netting for SFTs in accordance with Article 220 (1) to (3) and Article 222 CRR, but without any detail regarding the netting of cash receivables from repos/reverse repos. If the **Delegated Act aims to mimic Basel 3, it should include a separate new paragraph in Article 429 (9) with the above amended BCBS 270 point 33(i) c.**

2.2.2.3 European specificities vs US specificities for repos transactions settlement

a) US repo market is mainly based on a 'tri-party repos framework, which represents 65%-80% of the transactions.

Tri-party repo is a transaction for which post-trade processing --- collateral selection, payment and settlement, custody and management during the life of the transaction --- is outsourced by the counterparties to a third-party agent. In the US, there are only **2 clearing banks**: JP Morgan and Bank of New York Mellon.
Term repos in US tri-party systems have traditionally **unwound each morning**, to be re-arranged in the afternoon.
This was intended to give sellers (who are usually broker-dealers) the daily opportunity to substitute collateral and adjust for price fluctuations (instead of margining with the other party), but it requires the tri-party agents to finance the sellers for most of the day, creating a **systemic intra-day credit exposure**. Concern about the systemic risk posed by the huge intra-day credit exposures taken by the US tri-party agents have prompted **reforms to the US tri-party market** which are bringing it closer to the European tri-party model.

CF. The Federal Reserve in the 21st Century: Tri-party repo market reform, March 2013
CF. Federal Reserve Bank of New York: The Tri-Party Repo Market before the 2010 Reforms, November 2010

b) The European repo market is more diversified in terms of settlement process, and more secure

According to the 26th repo market survey (as of 11 December 2013 position) published in January 2014 by the International Capital Market Association (ICMA) and European Repo Council (ERC), on December 2013, the sum of repo and reverse repo outstanding (gross values of cash due to be repaid by you and repaid to you) reaches EUR **5,499** billion.

b.1 - The bilateral transactions excluding those cleared through CCPs represent 50%-60% of the total European market share

In Europe, most bilateral repos (both on a bilateral basis and tri-party) are settled via delivery-versus-payment mechanism, mechanism which links a securities transfer and a funds transfer in such a way as to ensure that delivery occurs if – and only if – the corresponding payment occurs.
Cf. CPSS – Strengthening repo clearing and settlement arrangements – September 2010; Annex 2: Cross-country comparison of repo markets and repo infrastructure arrangements in selected CPSS countries; (e) Settlement; P45-46-47-48).

The settlement is done through **Central Securities Depositories (CSDs).**

The two largest continental Central Securities Depositories (CSDs) Clearstream and Euroclear concentrate around 65% of settled repo transactions. *This information is given by the European Securities and Markets Authority (ESMA) paper published in March 2014 "Trends, Risks and Vulnerabilities*".

b.2 - The European market share of CCP-cleared (anonymous electronic) trading amounts to 30% -40%.

CCP is the acronym for *central (clearing) counterparty*. In some markets, they are known as *clearing houses*. CCPs perform two so-called *clearing* functions:

• Once a transaction has been agreed between two parties and registered with a CCP, the CCP inserts itself into the transaction (what was one contract becomes two) to become the buyer to every seller and the seller to every buyer. The CCP is AAA-rated, because it strictly collateralizes its exposures; is backed by reserves, a default fund and other safeguards; and can ultimately fall back on its members. CCPs therefore provide attractive low-risk counterparties.

• The CCP will net transactions between members on a multilateral basis (netting by a CCP is referred to as "clearing"). This means that a delivery of a security due from parties A and B can be netted off against deliveries of the same security due on the same day to parties C and D. This produces a much smaller net exposure than bilateral netting, in which the parties can only net transactions with the same counterparty.

The proportion of repo turnover cleared across a CCP is likely to be even higher because the repos cleared in CCP tend to be short-term transactions (the ECB's money market survey suggests in the order of 40%).

The principal CCPs clearing repos in Europe are LCH-Clearnet Ltd in the UK, LCH-Clearnet SA in France, Eurex Clearing in Germany, CC&G in Italy and MEFF in Spain.
Most CCP-cleared repos are negotiated on automatic repo trading systems such as BrokerTec, Eurex Repo and MTS.

b.3 - The tri-party repo transactions represent 10% of the total European market share.

The outstanding value reported directly by the major tri-party agents in Europe reached a record figure of EUR 1,344 billion.
The tri-party repo market in Europe is more secure than in the US, due to the fact that **tri-party repos in Europe are not unwound on a daily basis but subject to margining**. In European tri-party systems, there has always been true term repo. In Europe, the need to unwind tri-party repos daily has been avoided by the use of direct substitution and margining.
From the point of view of systemic risk, tri-party is not necessarily safer than bilateral. Tri-party agents, albeit they create economies of scale and scope for servicing the transaction, they DO NOT act as clearers, ergo they DO NOT guarantee the transaction, ergo DO NOT contribute to a decrease in the systemic risk. It is correctly shown in the chart that counterparties remain exposed to each other, same as in bilateral repos. Notably, it is the bilateral transactions which in most cases settle through DVP which is by far the safest way to ensure that transactions are finalized, settled, and cannot be unwound anymore.

Synthesis	Parties to the trade	**Administrative tasks**	**Risks**
1 - OTC Repos (on a bilateral basis)	Bank A trades Principal-to-Principal with Bank B	- Calculation agent : Bank A & B - Collateral eligibility : determined by the CSA between Bank A & B - Settlement of payments : Bank A & B (through their Back-Office teams	Counterparty and settlement risks against each bank
2 - Repos cleared through CCP	Bank A trades Principal-to-Principal with a CCP ("anonymous basis")	- Calculation agent : the CCP - Collateral eligibility : imposed by the CCP - Settlement of payments : Bank A & the CSDs (through their Back-Office teams)	Counterparty and settlement risks against the CCP
3 - Tri-Party repos	Bank A trades Principal-to-Principal with Bank B and a Clearing Bank acts as agent	- Calculation agent : the Agent Bank - Collateral eligibility : contractual or either General Collateral (GC) - Settlement of payments : the Agent Bank	Counterparty risk against each bank Settlement risk against the agent In addition : Intraday Exposure for the clearing Bank which finances securities during the day (the "unwind" in US market) to facilitate clearing and settlement activity of dealers

In the leverage ratio BCBS 270 text, the requirement of "settlement" criteria for netting the cash legs seems generating an unlevel playing field for European repo market, when the settlement is done on a bilateral basis, whereas bilateral transactions are settled through DVP and CSDs, which guarantee a functional equivalent of net settlement.

➔That is why the BCBS and CRR texts should be amended carefully to cover European repo market specificities. The re-worded 33(i)c in the BCBS 270 aims to cover all European repos

"*The counterparties intend to settle net"* – this is a catch-all, including CCP-cleared transactions

"***or*** *settle simultaneously"* – this covers DVP

"*or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement, that is, the cash flows of the transactions are equivalent, in effect, to a single net amount* ***at the end of*** ~~***on***~~ *the settlement date.* ***This will occur if the gross settlement mechanism has features that eliminate, or result in insignificant credit and liquidity risk****."* – this arrangement would have to apply for:

a) transactions involving baskets of securities (where DVP is not possible because as it would require to go cash-against-ISIN for every single security in the basket and therefore there would rather be an aggregate settlement on the settlement date equivalent to net of all the legs),
b) free-of-payment (FOP) purely bilateral transactions with the same counterparty, the same settlement date and the same ISIN number (which are settled leg-by-leg, as agreed by the counterparties)
c) tri-party transactions, including transactions involving baskets of securities, where the settlement is internalized by the tri-party agent and it is done either simultaneously (i.e. it already falls under the previous criterion) or in most cases at the end of the day, on a net basis.

"To achieve such equivalence, both transactions are settled through the same settlement system" – this is satisfied for a) and b) above when transactions are settling in a CSD (or an iCSD), as well as for c) when the settlement is internalized by the tri-party agent.

"…and the settlement arrangements are supported by cash and/or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day and the linkages to collateral flows do not result in the unwinding of net cash settlement." – this would mean:
a) and b): in the bilateral context where there is no DVP (i.e. not settled simultaneously), this condition would require that the counterparty has an intraday credit line with its custodian.
c) in the tri-party context the tri-party agent would have to extend an intraday credit line to the counterparty for the purpose of securing the transaction. This is the case both for US and EU tri-party arrangements.

2.2.3 Securities Financing Transactions: the condition for the exceptional treatment for a bank acting as agent (Points 36 and 37 in BCBS) needs to be clarified

2.2.3.1 BCBS should provide appropriate guidance on paragraph 36

In Paragraph 36, BCBS allows a bank acting as agent to include in the exposure only the add-on, exempting the gross assets, under condition if it "provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided."

In agency lending, the indemnity on behalf of the agent for the default of the borrower, as a standard market practice, extends contractually to expenses relative to servicing the transaction, such as corporate actions (coupon and dividend payments due during the time of the transaction), and billing (lending fees due on behalf of the borrower). These amounts are insignificant compared to the exposure resulting from the actual transaction, and should not trigger the obligation to include the entire value of the transaction in the agent's exposure. Moreover, in most cases the value of the collateral exceeds the value of the transaction (between 102% and 105% on average), which would allow these amounts, in case the agent should indemnify the borrower for their value, to be recovered under the value provided by the collateral.

BCBS should provide appropriate guidance on "any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided"

2.2.3.2 Fulfillment of Article 37 in the BCBS 270 text

In Article 37, if the indemnity extends beyond the delta between the value of the transaction and the value of the collateral, the bank acting as an agent is required to take into account the full amount of the security or cash. From our point of view, the exemption provided in Point 36 should be extended to transactions **where the agent has the legal right to liquidate the collateral in order to indemnify the lender for the borrower's default**.

The condition in point 37 in the BCBS 270 should have been written as follows:

A bank acting as agent in an SFT and providing an indemnity or guarantee to a customer or counterparty will be considered eligible for the exceptional treatment set out in paragraph 36 *only* if the bank's exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent and the value of the collateral the borrower has provided. **Conditions for the application of the treatment under paragraph 36 should be deemed as satisfied when the transaction arrangement grants the agent bank, for the purpose o providing the indemnification to the lender, the legal right to liquidate the collateral provided by the borrower in the event of the borrower's default.** In situations where the bank **remains** economically exposed (i.e. beyond the guarantee for the difference **without the right to liquidate the collateral)** to the underlying security or cash in the transaction, a further exposure equal to the full amount of the security or cash must be included in the exposure measure.

2.2.3.3 Proposal to amend Article 429 (9) in the CRR text

In CRR, June 2013, Article 429 (9) refers to allowing netting for SFTs in accordance with Article 220 (1) to (3) and Article 222 CRR, but without any detail regarding the netting of cash receivables from repos/reverse repos.

PROPOSAL: The Delegated Act should include a separate new paragraph in Article 429 (9) with the above amended BCBS 270 point 37

2.2 Derivatives netting criteria

The Basel III Leverage Ratio framework should not be considered as completely stabilized because it still raises **many questions among the regulatory community and the industry, as explained above for SFTs (Cf. APPENDIX 2: GFMA-IIF Technical Recommendations sent to the BCBS on 17 March 2014).**

Another point that raises concern is the condition of "same currency" to allow partial netting of cash variation margins in derivatives transactions (Point 25 (iii) in BCBS) needs to be adapted to the market sound practices

3.1 Fulfillment of Article 25 (iii) , in BCBS 270 text

The final Basel rules text (paragraphs 25 to 26) introduced a treatment whereby variation margin paid in cash that fulfils **five** criteria can be deducted from the current replacement cost of the derivative (fair value). **One criterion is: "The cash variation margin is received in the same currency as the currency of settlement of the derivative contract."**

A bank may execute numerous derivatives (like basic cross currency swaps) with a counterparty, all of which are governed by the same Master Netting Agreement (MNA). In some cases, these derivatives may provide for different currencies of settlement of contractual payments. The purpose of a MNA is to provide for a single netting structure to cover all of these positions even when denominated in different currencies. If the same-currency criterion is applied on a narrow basis, inconsistencies would arise in the net exposure. MNAs necessarily rely on the principle that a single variation margin payment can be applied against multiple positions denominated in various currencies**. Cf. Appendix**

The condition in point 25(iii) in BCBS 270 should have been written as follows:
"The cash variation margin is received in the qualifying currency as set forth in the master agreement governing the related transactions."

3.2 Proposal to amend Article 429 (9) in the CRR text

In CRR, June 2013, derivatives exposures are calculated according to Current Exposure Method / Mark-to-Market Method, **without recognition of cash collateral**. **Delegated Act should add the cash variation margin treatment as a subparagraph to Article 429 (6) of CRR by copying the relevant Basel rules text (paragraph 25) with the (iii) condition amended as proposed above.**

2.3 Written Credit Derivatives

"The proposed framework also introduces an additional treatment for written credit exposures. In addition to the CEM (or NIMM) treatment of derivatives, the full effective notional value of written credit derivatives (the exposure measure for credit protection sellers) shall be included in the exposure measure.

We acknowledge that credit derivatives have a dual nature: they can be seen either as "usual derivatives" or guarantees in case of default of the reference entity. As a matter of fact, this dual nature is reflected in the solvency ratio: when an institution has a trading intent, credit derivatives' exposure is measured as for any other derivatives (Mark to market plus add-on). On the contrary, when the institution intends to provide a guarantee on the credit risk of the underlying, credit derivatives are booked in the banking book and measured with the notional value.

We do not agree with the treatment that consists in systematically considering credit derivatives as guarantees. Most credit derivatives in banking institutions are booked in trading books and managed as any other derivatives: as such, they should be treated as any other derivative through the uses of Mark to market plus add on. The proposed treatment (notional value) also leads to a dissymmetric consequence: the writer shall declare the notional as an exposure whist the counterparty has entered into a derivative transaction (not a purchase of protection). In addition, if and when a written credit derivative is exercised, the seller of the derivative pays the notional amount to the buyer and receive from the buyer an unsecured claim (a loan or bond) against the reference entity. As such a full notional amount measure is in fact always overestimated and could at least be deducted by the recovery value of the claim against the reference entity. There is no leverage for the counterparty that writes a CDS in the trading book (except for the mark to market)"

Therefore, we believe that only derivatives classified as guarantees be subject to the proposed treatment.

2.4 Intragroup transactions: for solo calculus of the leverage ratio, intragroup transactions must not be considered

Our position: intragroup exposures should be exempted from the Leverage ratio to avoid double-counting

We request that the exposures between institutions belonging to a same group (intragroup exposures), should not be taken into account in the leverage ratio calculation when the 5 conditions stated in CRR Art. 113.6[7] are met.

To include intragroup exposures in the leverage ratio calculation is detrimental. This:

- **would trigger a leverage ratio higher at the largest level of consolidation**;
  As far as the Basel regulation is concerned, only a group leverage ratio is required. As a result, intragroup exposures are not penalized as they are eliminated on consolidation. If intragroup deals were to be included, this would imply that own funds would need to be allocated to every tier of consolidation to cover for intra-group exposures. This would trigger a leverage ratio higher than 3% at the largest level of consolidation. Moreover, banks cannot optimize capital allocation inside a Group according to two fundamentally different criteria: the risk weighted assets and the total of balance sheet ; for example between two entities, one having a high total balance sheet but low risks (retail) and another one having heavier risks but a reduced balance sheet. Banks clearly favor the risk criterion which has been the focus of progress in the financial industry for 25 years. The basis of management has to remain an analytical approach by entity based on risk-weighted assets and not on total of the balance sheet.

- **would discourage cash pooling** whereas regulators are willing to favour it;
  Banks that have transferred their capital markets activities into dedicated subsidiaries will be more particularly hit by the penalizing treatment of leverage ratio than others: there are cases where a mother company may comply from far with the leverage ratio requirement at consolidated level, though its subsidiary may meet difficulties to achieve such a requirement on a standalone basis. In such a case, acting as a separate entity is clearly penalizing for the subsidiary, because its leverage ratio footprint will not benefit from the 'umbrella effect' that the mother company may provide. On the opposite, should its activities have been integrated within the mother company, the subsidiary would have complied with the LR requirement.
  This 'umbrella effect' is also deemed to appear when the activities of such subsidiaries - like SFTs or Derivatives - are capital consuming from a Leverage ratio point of view (though not from a RWAs perspective) whereas the activities of the mother company are not.

- **would penalize unfairly cooperative groups**, because of their decentralised structures which imply a lot of intragroup transactions.

[7] In appendix 3.

The main intragroup exposures concerned are:

- internal refinancing operations between the parent company and its affiliates;
- derivatives operations between the group's investment bank and other entities of the group: this way of operating is reinforced by the EMIR Regulation;
- financial guarantees.

For the capital adequacy ratio, art 113.6 of the CRR exempts rightfully intragroup exposures if certain strict conditions are met, among which:

- **transactions between two entities belonging to the same group;**
- **counterparties established in the same Member State;**
- **counterparty included in the same consolidation on a full basis.**

The delegated act should therefore allow the leverage ratio to benefit from the exemption of intragroup exposures using the same rules granted in the capital adequacy ratio.

APPENDIX 1: repos netting and leverage ratio calculus, an example

Two banks A and B enter into two repos transactions, within a master netting agreement framework, legally enforceable.

In the first transaction, A borrows 1000 from B with collateral of securities X for 1025. In a second transaction, B borrows from A 800 with collateral of securities Y for 820. The settlement dates of the two transactions differ.

1. OPENING BALANCE SHEETS

A

Trading assets X	1025	Equity	60
Trading assets Z	175	Borrowings	1000
		Other liabilities	140
	=====		=====
Total assets	1200	Total liabilities	1200

B

Trading assets Y	820	Equity	60
Cash	680	Borrowings	1100
		Other liabilities	340
	=====		=====
Total assets	1500	Total liabilities	1500

2. ACCOUNTING FOR REPO TRANSACTION (= credit)

A

Trading assets X	(1025)	Trading assets X pledged	1025
Cash	1000	Repo payable	(1000)

B

Repo receivable	1000	Cash	(1000)

3. ACCOUNTING FOR REVERSE REPO TRANSACTION

A

Repo receivable	800	Cash	(800)

B

Trading assets Y	(820)	Trading assets Y pledged	820
Cash	800	Repo payable	(800)

4. CLOSING BALANCE SHEETS

A

Trading assets Z	175	Equity	60
Trading assets X pledged	1025	Borrowings	1000
Repo receivable	800	Repo payable	1000
Cash	200	Other liabilities	140
	=====		=====
Total assets	2200	Total liabilities	2200

B

Trading assets Y pledged	820	Equity	60
Repo receivable	1000	Borrowings	1100
Cash	480	Repo payable	800
		Other liabilities	340
	=====		=====
Total assets	2300	Total liabilities	2300

5. LEVERAGE RATIO

Assuming that the settlement dates of the repo and of the reverse repo differ, under Basel 3, art 33 prohibits netting. So, the leverage ratios are:

Basel 3

	Bank A	Bank B
Before SFTs	5 %	4%
After SFTs	2,73 %	2,61 %

Under CRR art 220 interpretation 1

Netting must portray faithfully the credit risk assumed by the institution. So, within a legally enforceable master netting agreement in event of default, bankruptcy or insolvency, for leverage ratio calculus, netting is permitted between borrowings (legs cash + securities) and loans (legs cash + securities). A net liability cannot be deducted from BS total.

For A: (1025+ 800) – (1000+820) = 5

For B: (1000 +820) – (1025+800) # 0

The netting process cannot be made by accounting entries, as in a reverse repo, due to the accounting rules, the balance sheet does not show the posted collateral .

Leverage ratio after netting

A

Assets:

Trading securities Z	175	
Collateral X	1025	
Repo receivable net	5	
Cash	200	
	=====	
Total	1405	LR = 4, 27 %

B

Assets		
Trading securities Y	820	
Cash	680	
	=====	
Total assets	1500	LR = 4 %

The amount added in the accounting figures for A portrays adequately the additional credit risk resulting from the two SFTs, which is generated by the haircuts on the securities. The risk for A is on the securities X sold under repo, less the securities Y received in the reverse repos, after taking into consideration the net of the two cash exchanges.

Conversely, B is a net debtor in the SFTs.

To summarize, in order to portray adequately the marginal credit risk added to the balance sheet by securities financing transactions executed within a master netting agreement, the measure of SFTs exposure should correspond, for an institution, to the total amount of security and cash given to a counterparty, less the total amount of securities and cash received from the same counterparty.

APPENDIX 2: Master agreement governing the related transactions (2014 03 18 GFMA-IIF FAQs sent to the BCBS)

The BCBS leverage framework refers to the "currency of settlement," a concept which may result in confusion when applied to financial markets practice. For the reasons set forth below, we request clarification that **any variation margin payments received by the banking organization should only be recognized as exposure-reducing when the payments are made in the currency or currencies identified in the collateral agreement, for example the Credit Support Annex (CSA) to the Master Netting Agreement (MNA).** There are three distinct concepts that the Basel Committee should distinguish between when implementing these rules.

First, a banking organization may execute numerous derivatives with a counterparty, all of which are governed by the same MNA. In some cases, these derivatives may provide for different currencies of settlement of contractual payments. The purpose of an MNA is to provide for a single netting structure to cover all of these positions with cash flows in different currencies. The net amount determined utilizing a spot FX conversion and expressed in a single currency, forms the basis for margin calls as well as the net settlement upon a termination of the MNA.

Second, a banking organization may be required under an MNA to make **a single margin payment on a daily basis with respect to the net variation margin amount owed for all of the positions covered by the MNA,** after completion of the netting process described above. This single net margin payment will be made in the currency or currencies identified in the CSA (or relevant collateral agreement) to the MNA. We believe that the reference in the BCBS leverage framework to "currency of settlement" logically applies at this step, so that, as described above, any variation margin payments received by the banking organization should only be recognized as exposure-reducing when the payments are made in the currency or currencies identified in the CSA to the MNA.

Finally, there is **the currency (or currencies) in which the cash flows of individual derivative transactions naturally occur, which may be different from both the close-out currency of the MNA and the CSA currency (ies)**.

By way of illustration, consider a banking organization that has 100 derivatives positions with a counterparty, all of which are governed by the same MNA. The 100 derivatives positions include contracts with cash flows in four major currencies (e.g., USD, EUR, JPY and GBP). On a daily basis, the banking organization determines the mark-to-market position of each of the 100 derivatives positions and determines a net amount owed to (or by) the bank as variation margin. The CSA between the parties identifies the currencies for payment of variation margin (e.g. USD or EUR). In this case, any variation margin payments received by the bank in USD or EUR will reduce the exposure of the bank, even though some of the underlying positions have cash flows in other currencies (e.g., JPY and GBP).

As the example illustrates, if the same-currency criterion is applied on a narrow basis, inconsistencies would arise in the net exposure / net replacement cost (RC) calculation**. Banks calculate the net mark-to market (MTM) across currencies by converting multiple currencies at spot FX rates into a single net amount, for a given MNA**. MNAs necessarily rely on the principle that a single variation margin payment can be applied against multiple positions with cash flows in various currencies, with the positions owed in each currency determined in accordance with spot FX rates.

Applying the same-currency criterion narrowly would result in anomalous outcomes. If the same-currency requirement were applied at the first step described above, margin payments that would be recognized as an offset to the derivative exposure under relevant accounting and regulatory regimes would not reduce a banking organization's leverage exposure and would be inconsistent with market practices.

In addition this would incentivize banks to bilaterally exchange variation margin in different currencies, to fulfil the currency matching criteria in a narrow interpretation. A bilateral exchange of VM in different currencies will, however, significantly increase the **cross-currency settlement risk** resulting from timing differences between the posting and the receipt of cash VM (Herstatt risk). Currently the market practice is to make a single net cash VM payment in an agreed transport currency. Incentivizing banks to make individual VM currency flows go out at potentially different times introduces **significant intraday settlement risk** if its counterparty defaults between cash-flows *(cf. example 4 below)*

To the extent FX risk arises due to differences between the currency of VM received and the other contract settlement currencies, it is quite small, given it is limited to short-term timing differences (e.g., if FX rates move one day, additional collateral will be called the next day). Such timing differences are risk managed to a minimum through requirements for frequency of margin transfer, low thresholds for transfer, low minimum transfer amounts and initial margin.

In fact, we are concerned that to apply the same currency criterion narrowly, as either transaction currency or MNA settlement currency, would be **FX risk increasing** given the current market practice for counterparties to enter into a CSA depends on the counterparties' access to specific currencies. A requirement to post variation margin, which serves as a form of pre-settlement payment, in either the MNA settlement currency or transaction settlement currency of the derivative, could create issues for foreign branches of internationally active banks that generally have more limited central bank access: this new structure of CSA would create multiple currency funding risks due to the potential inability to access multiple currencies in times of stress and hence counterparties would be reluctant to sign such CSAs.

Example 1:
Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. "MNA settlement currency" is USD.
All values (regardless of currency are shown in USD equivalent values)
USD MTM = +300
YEN MTM = -100
Net MTM = +200
If uncollateralized, exposure = 200
If currency of settlement = CSA permitted currency
    Case 1a = client posts 200 EUR – Leverage exposure would be 0
    Case 1b = client posts 200 USD – Leverage exposure would be 0
If currency of settlement = "MNA settlement currency"
    Case 2a = client posts 200 EUR – Leverage exposure would be 200
    Case 2b = client posts 200 USD – Leverage exposure would be 0
If currency of settlement = Transaction currency
    Case 3a = client posts 200 EUR – Leverage exposure would be 200
    Case 3b = client posts 200 USD – Leverage exposure would be 0

Example 2:
Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. "MNA settlement currency" is USD.
All values (regardless of currency are shown in USD equivalent values)
USD MTM = +300
YEN MTM = +100
Net MTM = +400
If uncollateralized, exposure = 400
If currency of settlement = CSA permitted currency
Case 1a = client posts 400 EUR – Leverage exposure would be 0
Case 1b = client posts 400 USD – Leverage exposure would be 0
Case 1c = client posts 300 USD and 100 EUR – Leverage exposure would be 0
If currency of settlement = "MNA settlement currency"
Case 2a = client posts 400 EUR – Leverage exposure would be 400
Case 2b = client posts 400 USD – Leverage exposure would be 0
Case 2c = client posts 300 USD and 100 EUR – Leverage exposure would be 100
If currency of settlement = Transaction currency
Case 3a = client posts 400 EUR – Leverage exposure would be 400
Case 3b = client posts 400 USD – Leverage exposure would be 100
Case 3c = client posts 300 USD and 100 EUR – Leverage exposure would be 100

Example 3:
Trades are subject to a Master Netting Agreement with a related CSA. The CSA allows for settlement in Euro or US Dollars. "MNA settlement currency" is USD.
All values (regardless of currency are shown in USD equivalent values)
USD / EUR Cross Currency Swap MTM = +400
Net MTM = +400
If uncollateralized, exposure = 400
If currency of settlement = CSA permitted currency
Case 1a = client posts 400 EUR – Leverage exposure would be 0
Case 1b = client posts 400 USD – Leverage exposure would be 0
If currency of settlement = "MNA settlement currency"
Case 2a = client posts 400 EUR – Leverage exposure would be 400
Case 2b = client posts 400 USD – Leverage exposure would be 0
If currency of settlement = Transaction currency (both currencies of swap)
Case 3a = client posts 400 EUR – Leverage exposure would be 0
Case 3b = client posts 400 USD – Leverage exposure would be 0
If currency of settlement = N/A, as there is no single settlement currency of the swap (that involves EUR / USD cash flows)
Case 4a = client posts 400 EUR – Leverage exposure would be 400
Case 4b = client posts 400 USD – Leverage exposure would be 400

Example 4:
A further example to illustrate the complexity of applying a narrow application based on transaction currency (in which the exposure is reduced only if the VM currency = derivative transaction currency)
(All values shown in USD equivalent; the currency sign indicates the currency of the USD equivalent values)
USD MTM = +100
EUR MTM = +50
GBP MTM = -80
If uncollateralized, exposure = 70
- There are potentially three approaches to allocate this MTM asset to the related derivative transaction currencies:
    i) Assume first allocate to $ -> $70
    ii) Assume first allocate to € then to $ -> €50 + $20
    iii) Proportionally to gross asset-> ($100/150)*70 + (€50/150)*70 = $(2/3)*70 + €(1/3)*70
- If client posts 70 in USD, under the corresponding approaches
    i) leverage exposure would be $70 - $70 = 0
    ii) leverage exposure would be €50 + max(0,[$20-$70]) = €50
    iii) leverage exposure would be max{0, [$((2/3)*70) - $70]} + €(1/3)*70 = €(1/3)*70
- If client posts 70 in EUR, under the corresponding approaches
    i) leverage exposure would be $70 (not allowed to net)
    ii) leverage exposure would be $20 + max(0,[€50-€70]) = $20
    iii) leverage exposure would be max{0, [€((1/3)*70) - €70]} + $(2/3)*70 = $(2/3)*70

If client posts in USD one would prefer to adopt approach (i). Otherwise if client posts in EUR one would opt approach ii) and so on. Further, as more currencies are involved in the MNA, the possible approaches can be further complicated and the permutation of possible scenarios would increase substantially. Given the potential complexity on how the netting logic would be applied, banks will make their own interpretations, creating potentially large differences in the implementation across banks. This would seem to be contrary to the objective of simplicity and transparency.

This example demonstrates that the narrow application results in an incentive for banks to bilaterally exchange variation margin in different currencies, i.e. in this case to post GBP 80 while receiving USD 100 and EUR 50. In this scenario the currency matching requirement in the narrow application is always fulfilled –independent of the interpretation - and thus the bank is able
- to fully offset the derivative mark-to-market exposure as the VM was received in USD and EUR to offset the derivative exposures of the derivatives with a positive market value in USD and EUR, and
- to exclude the cash receivable due to the posting of the GBP 80 due to the derivative liability in the same amount in GBP

Note however that **such a bilateral exchange of VM will significantly increase Herstatt risk. Currently the market practice is to make a single net cash VM payment in an agreed transport currency**. Breaking that netting would make individual VM currency flows go out at potentially different times. So a bank which has to pay VM in GBP but receives VM in USD would face a potentially significant intraday settlement risk if its counterparty defaults between cash-flows. This can be very significant amounts at coupon payment dates or at the maturity of large transactions.

APPENDIX 3: article 113.6 of REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013

6.With the exception of exposures giving rise to Common Equity Tier 1, Additional Tier 1 or Tier 2 items, an institution may, subject to the prior approval of the competent authorities, decide not to apply the requirements of paragraph 1 of this Article to the exposures of that institution to a counterparty which is its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking linked by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC. Competent authorities are empowered to grant approval if the following conditions are fulfilled:

(a) the counterparty is an institution, a financial holding company or a mixed financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements;

(b) the counterparty is included in the same consolidation as the institution on a full basis;

(c) the counterparty is subject to the same risk evaluation, measurement and control procedures as the institution;

(d) the counterparty is established in the same Member State as the institution;

(e) there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the institution.
Where the institution, in accordance with this paragraph, is authorised not to apply the requirements of paragraph 1, it may assign a risk weight of 0 %.