Coalition for Derivatives End-Users

July 6, 2023

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Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Mr. Michael J. Hsu
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street SW
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Ms. Debra Buie Decker
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington DC 20429

Re: ***Consideration of the Basel III Endgame Reforms and their Impact on the End-User Community***

The Coalition for Derivatives End-Users (the "Coalition") respectfully submits this letter to express its concerns about aspects of forthcoming changes to capital requirements for large banks commonly referred to as the Basel III Endgame package of reforms, and to emphasize the need for the Federal Banking Agencies[1] to consider carefully the numerous effects the implementation of certain changes could have on the end-user community

The Coalition represents end-user companies that employ derivatives primarily to manage commercial risks associated with their businesses. Hundreds of companies have been active in the Coalition on both legislative and regulatory matters and our message is straightforward: financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users would create more economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy—and may result in less hedging by end-users.

The use of derivatives to hedge commercial risk benefits the global economy by allowing a range of businesses—from manufacturing to healthcare to agriculture to energy to technology—to improve their planning and forecasting and offer more stable prices to consumers and more stable contributions to economic growth. Banking organizations that may be subject to the new Basel III Endgame capital requirements serve as critical counterparties to end-users for their derivatives transactions. They also serve as capital markets intermediaries, sources of stable credit, underwriters of corporate debt and equity securities and liquidity providers, and play other critical financial intermediary roles. Based on public statements from the heads of the Federal Banking Agencies, independent analyses of Basel III Endgame reform proposals underway in the EU and

[1] For purposes of this letter, the "Federal Banking Agencies" consist of the Department of the Treasury's Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation.

the UK and expected proposed changes here in the U.S., these new proposals could significantly increase capital requirements for the largest U.S. and non-U.S. banks that provide the bulk of derivatives-related products and services to corporations of all sizes and across many different, diverse sectors of the economy, including many Coalition members. These corporations use derivative products to hedge and mitigate commercial risks associated with their businesses, including interest rate risk, foreign currency risk and commodities risks. Coalition members' ability to hedge and mitigate such commercial risks is crucial to their business operations and the broader U.S. economy and the Coalition has concerns that the availability and cost of and competition for the delivery of such products, could be materially adversely affected in the wake of changes implemented under the Basel III Endgame's reforms. Therefore, we urge the Federal Banking Agencies to undertake a thoughtful approach to design an adjusted and balanced framework that, on the one hand, promotes safety and soundness and resolvability, bolsters financial stability and provides clarity to the markets and, on the other hand, does not diminish large banks' critical role as financial intermediaries, mitigates potential impacts on derivatives end-users and minimizes potential downside to the broader U.S. economy.

We are particularly concerned that specific aspects of the trading book components of the Basel III Endgame reforms could lead to reduced bank participation in certain financial markets—which would increase risk to financial stability and the broader U.S. economy by concentrating these products in less transparent markets and would increase costs for end-users. If these issues are not appropriately calibrated and balanced by the Federal Banking Agencies against those bank-specific risks that the Federal Banking Agencies are intending to address through the Basel III Endgame reforms, the new rules will have serious consequences to end-users and far-reaching negative implications for the broader U.S. economy, economic growth, competition and financial stability.

It has been estimated that implementing the Basel III Endgame reforms could result in an approximately **57 percent** increase in the capital requirements for banks' trading activities.[2] This increase is planned despite the fact that Federal Reserve Vice Chair for Supervision Michael Barr has noted on several occasions in written testimony or other formal remarks, including as far back as his nomination hearing before the Senate Banking Committee and as recently as May 18, 2023, that capital and liquidity in the financial system is very strong, a sentiment echoed by current and former regulators.[3] Indeed, Common Equity Tier 1 capital (the highest quality form of bank

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[2] *See* PWC, "Basel III Endgame: The next generation of capital requirements," at 1 (April 2023), *available at*: https://explore.pwc.com/baseliiiendgame/basel-iii-endgame-exsumm.

[3] *See*, *e.g.*, *Nominations of Michael S. Barr, Jaime E. Lizarraga, and Mark Toshiro Uyeda, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 118th Cong, at 15 and 18, *available at*: https://www.congress.gov/117/chrg/CHRG-117shrg48337/CHRG-117shrg48337.pdf; *Oversight of Financial Regulators: Financial Stability, Supervision, and Consumer Protection in the Wake of Recent Bank Failures, Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 118th Cong. at 1 (statement of the Honorable Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System), *available at*: https://www.banking.senate.gov/imo/media/doc/Barr%20Testimony%205-18-23.pdf; *see also*, *Transcript of Chair Powell's Press Conference* (March 22, 2023), *available at*: https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf; *Remarks by Secretary of the Treasury Janet L. Yellen at Financial Stability Oversight Council Meeting* (April 21, 2023), *available at*: https://home.treasury.gov/news/press-releases/jy1431.

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capital) levels at the largest U.S. banks grew more than three-fold between 2007 and 2023.[4] This increase, combined with a range of other post-crisis reforms, has made the largest U.S. banks far safer and has reduced risks such banks pose to the broader economic and financial system and financial stability.

As you know, large U.S. banks play a central role in the U.S. and global financial system through, among other things, capital formation and liquidity provision to the U.S. capital markets. The U.S. capital markets fund nearly three-quarters of all U.S. economic activity, making them a crucial source of financing and risk management services for a wide range of end-users. Nevertheless, significant increases in capital requirements in recent years have caused banks to pull back from key capital markets activities, resulting in higher costs for end-users and their customers, reduced competition and transparency in those markets, and signs of diminished liquidity and efficiency in some markets, particularly during periods of stress—all of which increase risk to financial stability.

In our view, the Basel III Endgame reforms' capital requirements for large banks would dramatically accelerate this trend, thereby increasing risk further. For example, the effects on trading activities resulting from the Fundamental Review of the Trading Book, Credit Valuation Adjustment and the Securities Financing Transaction minimum haircut floor portions of the Basel III Endgame reforms would force large banks to either pass on those costs of higher capital to end-users and their customers or simply withdraw from some capital markets activities altogether which, in the latter case, would increase concentration risk in less regulated, more opaque markets.

Moreover, the nearly 60 percent increase in the capital requirements for banks' trading activities is expected to significantly impact commercial hedging activities. For example, the cost of hedging foreign exchange risks would likely increase, as would the costs of entering long-dated interest rate swaps. The higher costs would at least partially negate adjustments made to the Standardized Approach to Counterparty Credit Risk rule that were designed to protect the cost savings afforded to end-users as a result of previously enacted Congressional relief. To help facilitate efficient access to the derivatives hedging market, Congress exempted end-users that are hedging business risks from having to post margin on uncleared derivatives transactions and from having to clear derivatives transactions.[5] These cost increases, coupled with the potential decrease in large bank participation in these markets, would hinder end-users' abilities to effectively hedge and reduce business risks. This, in turn, would discourage capital investments, economic growth and job creation.

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4 *See* SIFMA, "Identifying an Optimal Level of Capital and Evaluating the Impact of Higher Bank Capital Requirements on US Capital Markets" (May 15, 2023), *available at*: https://www.sifma.org/resources/news/identifying-an-optimal-level-of-capital-and-evaluating-the-impact-of-higher-bank-capital-requirements-on-us-capital-markets/.

5 *See* the Business Risk Mitigation Price Stabilization Act of 2015. "Forcing businesses to post margin not only ties up capital, but also makes it more expensive for firms to utilize the risk management tools that they need to protect their businesses from uncertainty. Today's bill clarifies in statute that Congress meant what it said when it exempted end users from margin and clearing requirements. Specifically, it ensures that those businesses which are exempt from clearing their hedges are also exempt from margining those hedges." 114th Congr. Rec. H-67-68 (Jan. 7, 2015) (state of Rep. Mike Conaway).

As the Federal Banking Agencies consider materially increasing both the overall and trading book-related capital requirements for the largest banks as part of the Basel III Endgame reforms, it is critical that the Federal Banking Agencies remain mindful of, and account for, the strong correlation between capital markets activities and the real U.S. economy and duly consider and balance the impact of any potential increases in bank capital requirements on the ability of end-users to effectively hedge important business risks at reasonable cost in highly regulated, more transparent markets. As an example, when an end-user hedges its interest rate, foreign exchange or commodity risk with a bespoke derivative product, that activity generates a derivative exposure for a large bank, that the bank will, in turn hedge. The Basel III Endgame reforms are likely to increase hedging costs, disincentivize prudent risk-management by corporations, and ultimately increase costs and risk and reduce investment in our economy. In that connection, we also request that the Federal Banking Agencies conduct and publish a broader cost-benefit analysis and assessment of both the economic benefits and costs of significantly increasing capital requirements above their already historically robust levels.

The Coalition stands ready to engage with the Federal Banking Agencies and other policymakers in this critically important work with the goal of ensuring that the final Basel III Endgame reforms carefully balance costs and benefits to create an adjusted and balanced framework that promotes safety and soundness and resolvability, bolsters financial stability, provides clarity to the markets and reduces complexity. At the same time, it is important that the new rules do not diminish large banks' critical roles as financial intermediaries, impede end-users' ability to safely and efficiently mitigate and manage their commercial risks or create unintended consequences to the detriment of the broader U.S. economy.

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Thank you for your consideration of these very important issues to derivatives end-users. Please contact Michael Bopp at 202-955-8256 or at mbopp@gibsondunn.com if you have any questions or concerns.

Yours sincerely,

Coalition for Derivatives End-Users

cc: The Honorable Jerome H. Powell, Chairman
The Honorable Michael S. Barr
The Honorable Michelle W. Bowman
The Honorable Lisa D. Cook
The Honorable Philip N. Jefferson
The Honorable Christopher J. Waller
(Board of Governors of the Federal Reserve System)

The Honorable Martin J. Greunberg, Chairman
The Honorable Travis Hill, Vice Chairman
The Honorable Rohit Chopra, Director
The Honorable Michael J. Hsu, Director (*addressee*)
The Honorable Jonathan McKernan, Director
(Federal Deposit Insurance Corporation)