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VIA ELECTRONIC TRANSMISSION

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

James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064–AF29)
Federal Deposit Insurance Corporation
550 17th Street NW Washington, DC 20429

Chief Counsel's Office
Attention: Comment Processing (Docket ID OCC–2023–0008)
Office of the Comptroller of the Currency
400 7th Street SW
Suite 3E–218
Washington, DC 20219

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity

Dear Mrs. Misback, Mr. Sheesley, and Mr. McDonough:

The Depository Trust & Clearing Corporation ("DTCC") and its subsidiary the Fixed Income Clearing Corporation ("FICC") appreciate the opportunity to comment on the above captioned proposal ("Proposal") by the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "Agencies") to amend various capital requirements for larger banking organizations and those banking organizations with significant trading activities ("Covered Institutions"). As we discuss further below, our comments are targeted at the Proposal's treatment of cross-product netting arrangements.

DTCC is the parent company of FICC, which is currently the only covered clearing agency for U.S Treasury security transactions regulated and supervised by the U.S. Securities and Exchange Commission ("SEC"). Through its Government Securities Division ("GSD"), FICC provides real-time trade matching, clearing, risk management, and netting for cash purchases and sales of U.S. Treasury securities as well as repurchase and reverse repurchase transactions involving U.S.

Treasury securities. Market participants created and continue to own DTCC and FICC both to reduce the risk of clearing and settling U.S. Treasury transactions and to manage the remaining risk in a way that protects participants and the wider market. In addition, many of the entities that are currently user-participants of FICC are Covered Institutions.

As a covered clearing agency, FICC is subject to the SEC's covered clearing agency standards.[1] In addition, the Financial Stability Oversight Council ("FSOC") has designated FICC as a systemically important financial market utility ("SIFMU") pursuant to Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[2] As a result of the SIFMU designation, the FRB has oversight authority for FICC.

Executive Summary

The Proposal would remove cross-product netting sets from the definition of a "netting set" and thereby limit "netting sets" to groups of single-product transactions that satisfy certain requirements.[3] By virtue of this change, it will not be possible for Covered Institutions to recognize, for regulatory capital purposes, the beneficial risk offsets that arise from cross-product margining arrangements.

The practical effect of this non-recognition is that the capital requirements applicable to a portfolio of transactions subject to a cross-product margining arrangement will be misaligned with the risks that portfolio actually presents. In particular, portfolios that present higher credit risk to the Covered Institution will have the same capital requirements as portfolios that are far less risky. For example, the capital rules will treat no differently a situation in which Customer A enters into a Treasury futures contract for the purpose of taking a directional view on interest rates from one in which Customer B enters into the Treasury futures contract to limit the interest rate risk Customer B has under a contract to purchase a Treasury security. This misalignment will distort incentives, with customers and Covered Institutions incentivized to maintain riskier portfolios, rather than limit their overall exposure across products, due to a lack of recognition of risk offsets in the capital requirements.

This misalignment is particularly unjustified when the transactions in the portfolio are cleared by one or more SIFMUs and subject to cross-margining adopted by such SIFMUs. In such a situation, the SIFMUs will have carefully and conservatively calibrated the risk offsets between product types, with the approval of at least one federal regulator, and under the oversight of the FRB. Accordingly, the risk of miscalibrated risk offsets is quite low. Moreover, failing to recognize cross-product netting for cleared positions will disincentivize central clearing as a whole and thereby lead firms away from the critical safety and soundness benefits central clearing can provide. For example, Customer B in the scenario above may determine that, since the capital rules will not recognize the risk offsets of its interest rate futures contract and Treasury purchase agreement, it may be preferable to enter into bespoke uncleared swaps with

[1] https://www.sec.gov/files/rules/final/2016/34-78961.pdf.
[2] https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/designations.
[3] https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant at p. 64059.

the Covered Institution that achieve the same investment objectives but qualify as part of a "hedging set" under the capital rules. Such a result will mean greater risk for Covered Institutions, not less.

To align the capital requirements applicable to a portfolio with the risk that portfolio presents and not unduly disincentivize risk mitigation, we recommend that the Agencies permit Covered Institutions to recognize cross-product netting agreements, at the very least, in situations in which: (i) the cross-product netting agreement is entered into in connection with a cross-margining arrangement offered by one or more SIFMUs, and (ii) the percentage in exposure reduction arising from the recognition of such cross-product netting agreement is no greater than the margin reduction percentage recognized by the SIFMUs under the associated cross-margining arrangement.

Overview of the FICC and CME Cross-Margining Product

FICC and the Chicago Mercantile Exchange ("CME") currently offer a cross-product cross-margining arrangement to incentivize effective risk management and clearing. At a very high level, the FICC-CME cross-margining arrangement permits common members of FICC and CME (or affiliated members of FICC and CME) to reduce the aggregate initial margin requirements they must post to FICC and CME in respect of a portfolio of eligible FICC and CME cleared positions (e.g., cash Treasury positions and Treasury futures) on the condition that the members provide FICC and CME with the ability to look to the value of the entire portfolio in the event of the members' default. The foundation of the cross-margining relationship between FICC and CME is a cross-margining agreement between the two SIFMUs in which they each agree that to the extent they have excess value or collateral on account of cross-margined positions following a member default (e.g., because the cash Treasury positions went up while the Treasury futures positions went down), they will turn over that margin to one another. The members, in turn, enter into agreements with the SIFMUs allowing that excess value and margin to be applied to their obligations to both SIFMUs.[4]

As a result of these agreements, FICC and CME are able to recognize risk offsets arising from the offsetting value of positions maintained by a member (or a member and its affiliate) at FICC and CME when calculating the margin requirements for those positions. As a matter of prudence, each of FICC and CME separately calculate these risk offsets for the entire portfolio of eligible trades and give effect to the more conservative of the two calculations. Any resulting margin reductions create capital efficiencies for common members. The agreement covers certain cash U.S. Treasury securities cleared by FICC's GSD and various specified interest rate futures products cleared by CME. The SEC and the Commodity Futures Trading Commission ("CFTC") recently approved amendments to the current cross-margining agreement (the "Amended Agreement"), which will be implemented on January 22, 2024. The amendments include: (i) an expansion of the scope of CME products eligible for cross-margining, allowing for greater potential margin offsets; (ii) simplification of the overall margin calculation process which, based on portfolio-specific construction and market conditions, should generate margin savings in excess of those under the existing cross-margining agreement; and (iii) improvement

[4] The FSOC has also designated CME as a SIFMU pursuant to Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

in the efficiency and effectiveness of the default management process that FICC and CME would engage in if a common or affiliated member, as applicable, were to default.[5]

The current cross-margining agreement and the Amended Agreement are only available for house (proprietary) accounts of CME clearing members that are also FICC/GSD netting members (or affiliates of FICC/GSD netting members). On November 6, 2023, the Global Market Structure Subcommittee of the CFTC's Global Markets Advisory Committee ("GMAC") recommended adoption of a regulatory structure to expand the current FICC-CME cross-margining arrangement beyond proprietary positions to also cover customer positions, thereby making the benefits of cross-margining available to a broader range of market participants. This recommendation was approved by the GMAC for review by the CFTC.[6]
Given these developments and ongoing market demand, FICC and CME are continuing their ongoing efforts to expand the benefits of cross-margining to a wider scope of market participants. This expansion is anticipated to include those customers who are affected by the SEC's recently adopted central clearing requirements for U.S. Treasury security transactions, where maximizing capital and margin efficiencies will be even more critical for market participants.[7]

Benefits of Cross-Product Netting Relationships

As a general matter, many cross-product netting arrangements, like the one present in the CME-FICC cross-margining product described above, can be used by banking organizations, and potentially their clients in the future (subject to regulatory approval in the particular case of the FICC-CME cross-margining arrangement), to hedge with great effectiveness many of the particular risks the Proposal is seeking to address. While interest rates were stable and low for an extended period of time following 2007, recent interest rate increases have exposed the risks on institutions' balance sheets that can exist when interest rate risk is mismanaged. The ultimate negative effects of mismanaged interest rate risk were seen in the failure of Silicon Valley Bank in March 2023, as a result, in part, of its poor interest rate risk management, particularly with regard to its U.S. Treasury securities portfolio.[8] Silicon Valley Bank was further disincentivized from hedging its U.S. Treasury securities interest rate risk due to the costs of hedging this exposure, while the bank was looking to limit expenses and maintain capital.[9]

The cross-margining arrangement between FICC and CME facilitates the mitigation of the balance sheet risks discussed above. Entities that utilize this arrangement are able to use CME cleared derivative products to hedge associated risks with U.S. Treasury security transactions cleared by FICC. Because these products are so intrinsically tied, they manifest themselves less as two unrelated products that institutions are looking to net, and more similarly to a single product transaction that is consistent with the definition of a "netting set" under the Proposal.

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[5] https://www.cmegroup.com/media-room/press-releases/2023/7/18/cme_group_and_dtcctoincreasecross-marginingopportunitiesforthetr.html.
[6] https://www.cftc.gov/media/9591/gmac_FICC_CME110623/download.
[7] https://www.sec.gov/files/rules/sro/ficc/2023/34-97969.pdf.
[8] https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf at p. 2.
[9] *Id.*

However, even if the GMAC proposal is adopted and client positions can also benefit from the FICC-CME cross-margining agreement, a Covered Institution and its customers will face reduced incentives to engage in customer-level cross-margining if the Proposal were to be finalized. Although the Covered Institution will be permitted to collect less margin under the FICC-CME cross-margining arrangement, without commensurate netting permitted in relation to the exposure calculation, the capital rules will view that reduced collection as resulting in a large unsecured exposure, which will leave the bank with a significant capital requirement that does not represent the risk of the netted and cross-margined portfolio.

Consider the following simplified example in which a subsidiary of a Covered Institution that is a common member of FICC and CME (a "Covered Clearing Member") carries for a customer a single CME cleared interest rate future that is eligible for the FICC-CME cross-margining arrangement. Assume for this purpose that, for purposes of the capital rules, the potential future exposure (the "PFE") for the position (without regard to collected collateral) is $1 million and that CME calculates an initial margin requirement (under its own methodology, similar to PFE calculations) with respect to the position of $1.1 million.

In accordance with CFTC's and CME's rules, the Covered Clearing Member will collect no less than $1.1 million of initial margin from the customer. Subject to any applicable haircutting for the collateral, this $1.1 million of initial margin will substantially reduce the capital requirement for the Covered Clearing Member in respect of the position's PFE. This reduction is in recognition of the fact that the collateral largely eliminates the Covered Clearing Member's credit risk exposure arising from the position's PFE.[10]

Now, assume that, in order to reduce its interest rate exposure, the same customer enters into a contract to purchase a Treasury security, which is cleared at FICC and is eligible for the FICC-CME cross-margining arrangement.[11] Assume further that, pursuant to the cross-margining methodology approved by the CFTC and SEC, FICC determines that the risk offsets arising from the cash Treasury position merit an initial margin reduction for the customer's futures positions of $400,000 and CME calculates a reduction of $500,000. Under the cross-margining arrangement, the initial margin requirement for the customer's position will be $700,000, rather than $1.1 million (i.e., the FICC-CME arrangement applies a conservative approach in calculating $1.1 million *less* the lower of the two reduction amounts calculated by FICC and CME). This reduction is based on the calculation that the PFE of the position is no greater than $700,000.

However, if the capital rules do not permit recognition of cross-product netting arrangements (even when the methodology for recognizing the cross-product risk-offsets has been carefully and conservatively calibrated by two SIFMUs and approved by the CFTC and SEC), then the PFE of the futures position (without regard to collected collateral) for purposes of the capital

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[10] The Covered Institution may still need to collect margin or hold capital against other exposures that the position creates, such as variation margin for current exposure.

[11] Pursuant to FICC's rules, FICC will, like CME, collect initial margin (known as "clearing fund") as well as variation margin (known as "funds-only settlement amounts") for the contract. For sake of simplicity, we have focused on the initial margin requirement for the interest rate futures contract.

rules will remain at $1 million. As a result, the Covered Clearing Member can either (i) collect from the customer the $700,000 that CME and FICC have determined effectively protects against the position's potential future exposure, but in doing so bear significantly higher capital requirements for the interest rate future position because it would be deemed to be left partially uncollateralized or (ii) require the customer to post $300,000 in excess of the amount required by FICC and CME in order to replicate the amount needed to offset the PFE under the capital requirements that apply in the absence of the cross-margining arrangement. In either case, the capital requirement would not accurately reflect the risk of the combined position, and the incentives of the Covered Clearing Member and the customer to have the customer limit its interest rate risk would be significantly diminished.[12]

Increase in Treasury Market Liquidity

Liquidity in the U.S. Treasury securities market is an immensely important concern for Covered Institutions, and for market stability as a whole, as the U.S. Treasury securities market is the largest, at $26.3 trillion outstanding[13], and most liquid market in the world.[14] Observers have suggested that netting in general and cross-product netting more specifically (and the related cross-margining benefits) would free resources that can be utilized to provide additional liquidity for the U.S. Treasury securities market[15], as well as decrease the need for additional margin calls that otherwise can cause entities to liquidate U.S. Treasury securities positions and decrease liquidity.[16] For similar reasons, research indicates that cross-margining improves overall financial market stability.[17]

Benefits of SIFMU Entities Managing Cross-Product Netting and Related Margining

For the FICC and CME U.S. Treasury securities products covered by their cross-margining agreement, the fact that each SIFMU involved in facilitating the cross-product netting and risk management of the ultimate portfolio exposure is subject to strict federal regulatory oversight and supervision provides protections to the banking organizations that utilize FICC and CME to clear theirs and their customers' cross-netted transactions, as well as promotes market stability in general. Specifically, this federal oversight of SIFMUs helps facilitate the SIFMUs' role in addressing counterparty risk, operational risk, and market risk, among other risks. In addition, because both CME and FICC are self-regulatory organizations, the process for the establishment, implementation, and enhancement of their cross-margining agreement and services involves review by each central counterparty's relevant federal regulators as well as the opportunity for public comment and consultation.

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[12] The customer's contract to purchase Treasuries may have its own capital requirements, especially if the Covered Clearing Member collects initial margin and variation margin in respect of the position prior to settlement. *See* 12 C.F.R § 217.38(b)(1). For the sake of simplicity, we have focused on the interest rate futures contract.

[13] https://www.sifma.org/resources/research/us-treasury-securities-statistics/.

[14] https://home.treasury.gov/system/files/136/20231106_IAWG_report.pdf at p. 3.

[15] www.bnymellon.com/content/dam/bnymellon/documents/pdf/aerial-view/future-proofing-the-us-treasury-market.pdf at p. 8.

[16] https://scholar.harvard.edu/sites/scholar.harvard.edu/files/stein/files/g30_paper.pdf at p. 14.

[17] https://som.yale.edu/blog/cross-margining-and-financial-stability.

In addition, further opportunities for entities to utilize FICC and CME for cross-product netting are expected to increase with the December 13, 2023 issuance by the SEC of a final rule requiring increased central clearing of U.S. Treasury security repurchase transactions and certain secondary market cash transactions, with FICC being the only entity that currently offers this U.S. Treasury securities clearing service.[18] This increased central clearing, in conjunction with the GMAC recommendation to expand the current FICC and CME cross-margining agreement to include customer positions, is expected to broaden the universe of entities that can utilize the benefits of the agreement, and therefore increase the criticality of the capital treatment of cross-product netting for Covered Institutions.

We also note that in availing themselves of the CME-FICC cross-margining product, banking organizations have come to rely upon the margin determinations of the SIFMUs calculated thereunder. As we have noted previously, the frameworks for these respective SIFMU margin determinations occur under close federal supervisory and oversight review and regulation. Therefore, it is also our recommendation that the Agencies limit the maximum reduction in potential future exposure to no more than the percentage of margin reduction agreed to by the SIFMUs (which is the lowest amount calculated by each of the individual SIFMUs clearing the cross margined transactions).

Closing

In a 2017 speech, then Governor Powell of the FRB noted the intersection of the benefits of central clearing with the prerogatives of bank capital requirements in observing, "Global authorities also have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[19] We agree with this statement and submit our comments to the Proposal in furtherance of this important policy point. As explained above, we respectfully recommend that the Agencies modify the current draft of the Proposal to include cross-product netting sets in the proposed definition of a "netting set." At the very least, and due to the specific safety and soundness considerations discussed above, we recommend that the definition of "netting set" include cross-product netting sets where both products are subject to a cross-product netting arrangement adopted by one or more SIFMUs and the percentage exposure reduction arising from the cross-product netting agreement is no more than the percentage of margin reduction agreed to by the SIFMUs under the cross-margining agreement.

[18] https://www.sec.gov/news/press-release/2023-247.
[19] https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm.

We appreciate the opportunity to submit this limited comment letter, and welcome further engagement with the Agencies to discuss our views on this important aspect of the Proposal further.

Very truly yours,

Brian Steele
Managing Director
President, DTCC Clearing & Securities Services

Laura Klimpel
Managing Director
General Manager, FICC

cc:

Mr. Haoxiang Zhu, Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Mr. Clark Hutchison, Director, Division of Clearing and Risk
U.S. Commodity and Futures Trading Commission

Mr. Brian Smith, Deputy Assistant Secretary for Federal Finance
U.S. Department of the Treasury