



THOMAS M. HOENIG  
VICE CHAIRMAN

November 30, 2015

The Honorable K. Michael Conaway  
Chairman  
Committee on Agriculture  
House of Representatives  
Washington, D.C. 20515

The Honorable Collin C. Peterson  
Ranking Member  
Committee on Agriculture  
House of Representatives  
Washington, D.C. 20515

Dear Chairman Conaway and Ranking Member Peterson,

Recently you shared a letter with the banking authorities raising concerns that “failing to recognize segregated margin could have materially adverse consequences on cleared derivatives markets, end users and market participants.” I appreciate your concerns and am sensitive to the damage that unintended consequences can have on markets and individuals. However, as you may know, I have long held the position that allowing segregated margin to reduce the derivatives portion of the leverage ratio would undermine its usefulness and compromise the safety and soundness of the largest banking organizations. I therefore would like to further explain these views. My main conclusion is that margin does not reduce the off-balance sheet exposure as the exposure is calculated for purposes of the leverage ratio.

### **Balance Sheet Effect and Margin**

When clearing a derivatives trade, a customer will work through a large banking organization that is a member of a CCP. The bank guarantees the performance of the customer to the CCP. That is, if the customer defaults, the bank will step in and perform on the derivatives contract with the CCP. This guarantee is unlimited in nature.

In a cleared transaction, the customer is required to post margin at the inception of the transaction. This margin amount is calculated by a model that estimates how much money could be lost on a derivative over a period of several days. If the margin is posted in cash, it is held in a “legally segregated, operationally co-mingled” (LSOC) account. In such accounts, the margin remains legally the CCPs, and investments are restricted by CFTC regulations to high-quality, short-term investments. That is the legally segregated portion. However, it is equally important that the accounts also are operationally co-mingled. Generally the bank that collects the margin directs the investments and retains any income on the investments. Thus, since the proceeds of the posting are invested, as any deposit is, therefore holding capital is appropriate, just as it is with all other on-balance sheet assets.

## **Leverage Ratio and Off-Balance Sheet Exposures**

The supplementary leverage ratio (SLR) includes an off-balance sheet portion of derivatives exposures and includes the effect of guarantees that are not recognized on-balance sheet. Therefore, derivatives that are cleared for clients are included in a bank's SLR because the bank provides an unlimited guarantee of its clients' derivatives positions.

An add-on for cleared derivatives is also included in the denominator of the SLR. The add-on is calculated by multiplying the notional value of the derivative by a conversion factor. The conversion factor is driven by: (a) the remaining life of the derivative; and, (b) the type of derivative. The factors range from 0% for an interest rate derivative with less than one year remaining, to a maximum of 15% for long-term contracts on certain commodities.

For example, the add-on for an equity derivative with a notional of \$10 and more than five years remaining is ( $\$10 * 0.10$ ), or \$1. The total add-on exposure amount is calculated on a net basis by counterparty such that the total amount can be reduced if contracts with the same counterparty are offsetting.

In this simple example, \$1 would be added to the denominator of the leverage ratio. However, it's important to note that, depending on the type of equity derivative, there's theoretically no limit to how much the bank that entered into this transaction could lose. These add-ons are estimates of amounts that could be lost over a period of time; they are not the full amount of potential off-balance sheet exposure.

For example, assume that AIG clears a \$100 million dollar credit default swap (selling protection on an investment grade name) and a \$1 billion interest rate swap (with a 3-year term) with Goldman Sachs. The add-on factor for the credit default swap is \$5 million and for the interest rate swap it is also \$5 million. The total add-on for the denominator of Goldman Sachs' leverage ratio will range from \$4 million to \$10 million, depending on whether and by how much the current values of the credit default swap and interest rate swaps offset each other.

Therefore, Goldman Sachs would have to hold leverage ratio capital of somewhere between \$200,000 and \$500,000 (using the 5% leverage ratio at the holding company level) to cover its potential exposure to AIG on these trades. If initial margin were allowed to reduce exposure, it would reduce the total add-on, thereby also reducing these required capital amounts.

If we further assume that there is a default in the reference name of the credit default swap, AIG would be forced to make a substantial payment to the CCP. If AIG were to fail to make this payment, Goldman Sachs would be responsible for making the payment to the CCP. Any margin collected would be available to Goldman Sachs to offset the payment; however, in the event of a default, the payment would almost certainly be well in excess of any initial margin that had been collected.

## Margin and Total Exposure

You raise an important question as to “why segregated customer margin does not reduce the bank's actual off-balance sheet exposure, especially when CFTC regulations circumscribe the manner in which it may be invested.”

I would offer three key explanations:

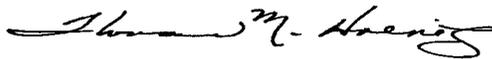
First, as suggested above, the leverage ratio does not include “the bank’s full off-balance sheet exposure” for guaranteed derivative positions. Instead it includes a model-based add-on of that exposure that is intended to reflect the risk of the derivative position that the bank is guaranteeing. The actual off-balance sheet exposure could be much higher (and in some crises could theoretically be unbounded).

Second, if, as the industry and their representatives have argued, the margin collected by banks protects against losses, there should be no reason why the banks provide an unlimited guarantee to the CCPs. Despite the fact that by their own logic this guarantee is superfluous, they continue to require this guarantee. If they provided a guarantee that did not go beyond the amount of the add-on calculated for leverage ratio purposes, it would be logical to reduce the add-on by the amount of margin that has been exchanged, but this is not the sort of guarantee they provide.

Finally, in principle, the leverage ratio does not recognize collateral. For example, a loan collateralized by a CD is not reduced for purposes of calculating the leverage ratio. If collateral is allowed to offset exposures in the leverage ratio, then bank balance sheets can be reduced to token amounts and the leverage ratio will be effectively turned into a risk-based capital ratio, which served the American public so poorly in this last crisis.

I recognize that there might be other factors that I have failed to consider and I would welcome the opportunity to discuss this further with you and your staff at your earliest convenience. I can be reached at (202) 898-3858.

Sincerely,



Thomas M. Hoenig

cc: Members of the United States Senate Committee on Agriculture, Nutrition and Forestry  
United States Senate Committee on Banking, Housing and Urban Affairs  
United States House of Representatives Committee on Financial Services