Statement by Martin J. Gruenberg

Member, FDIC Board of Directors

Final Rule: Standardized Approach for Calculating the Exposure Amount Of Derivative Contracts

November 19, 2019

This final rule before the FDIC Board today would implement a new methodology – the standardized approach for counterparty credit risk (SA-CCR) – for calculating the exposure amount of derivative contracts for advanced approaches banking organizations under the regulatory capital rule of the banking agencies.

This final rule also contains a provision, not included in the Notice of Proposed Rulemaking, which would allow for the recognition of collateral in the supplementary leverage ratio of a banking organization that is a member of a central clearing counterparty (CCP) in connection with a cleared derivatives transaction.

This provision would weaken the leverage capital requirement for derivative exposures for the largest, most systemically important banking organizations in the United States. It would also increase their vulnerability to the failure of a central clearing counterparty, one of the most significant risks to the U.S. and global financial systems that has developed since the financial crisis of 2008-2009.

For these reasons, I will vote against this final rule.

In the lead up to the financial crisis, over-the-counter (OTC) derivatives contracts were often poorly collateralized and lacked transparency. As the crisis developed, concern about the ability of counterparties to meet their obligations to OTC derivatives contracts grew, demands for the collateral on these contracts were made, and the stress of the crisis was exacerbated.

During the crisis, derivatives that were subject to central clearing were able to offset counterparty credit risk by ensuring adequate collateralization, providing greater market transparency to the transactions, and enabling netting of contracts.

In the aftermath of the crisis, there was international recognition of the value of central clearing for standardized over-the-counter derivatives contracts. The Summit of the G-20 Leaders in September 2009 in Pittsburgh stated that all standardized OTC derivative contracts should be cleared through central counterparties.[1]Consistent with that statement, the Dodd-Frank Act provided for mandatory clearing.[2]

The question of leverage ratio capital treatment of client cleared derivatives exposures has been the subject of much debate in the Basel Committee since the establishment of the clearing mandate in 2009. In October 2018, the Basel Committee sought public comment on this issue, stating:

"The Committee's post-crisis reforms…were motivated by key policy objectives set by G20 leaders: (i) to strengthen the regulatory frameworks, prevent excessive leverage and improve the quality and quantity of capital in the banking system; and (ii) to promote central clearing of standardised derivative contracts as part of mitigating systemic risk and making derivatives markets safer. In light of these overarching policy objectives, the Committee seeks the views of stakeholders as to whether a targeted and limited revision of the leverage ratio exposure measure is warranted with regard to the treatments of client cleared derivatives."[3]

Comment was sought on whether to retain the current treatment of client cleared derivatives, which would not take account of collateral to reduce the leverage ratio exposure measure, or to allow such recognition. In June 2019, the Basel Committee announced that it had agreed to revise the leverage ratio treatment of client cleared derivatives to permit such recognition.[4] That treatment has now been incorporated into the final rule before the FDIC Board today.

Even though the Basel Committee has now agreed to permit – not require – the recognition of collateral for client cleared derivatives in the leverage ratio,

[1] Leaders' Statement: The Pittsburgh Summit, G-20 (Sept. 24-25, 2009 at https://www.treasury.gov/resources-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act sections 723 (7 U.S.C. 2(h)) and 763 (15 U.S.C. 78c-3).
[3] Basel Committee on Banking Supervision Consultative Document: Leverage ratio treatment of client cleared derivatives (Oct. 2018) (footnotes omitted) at https://www.bis.org/bcbs/publ/d451.pdf.
[4] Basel Committee on Banking Supervision: Leverage treatment of client cleared derivatives (June 2019) at https://www.bis.org/bcbs/publ/d467.pdf.

there are compelling safety and soundness and financial stability reasons not to adopt such treatment.

First, the leverage ratio is supposed to be a simple, non-risk based measure of capital against the assets and exposures of the financial institution. The premise of allowing collateral to be recognized in the leverage ratio is the presumed risk mitigating value of the collateral against derivative exposures. However, this contradicts the basic purpose of the leverage ratio and undermines its value.

Second, the collateral for the derivatives exposure is supposed to protect against not only the replacement cost of the derivative but also the potential future exposure the derivative contract may entail depending on how markets move over the term of the contract. Since the clearing member banking organization typically guarantees the performance of the contract by the client, the exposure of the banking organization to the contract may far exceed the value of the collateral. The leverage capital the banking organization holds against the risk of the derivative exposure should thus not be reduced by allowing the collateral to be deducted from the exposure to the derivative contract.

Finally, and most fundamentally, there has been rapid growth in client cleared derivatives since the financial crisis. The biggest risk today is not the failure to clear client derivatives. The biggest risk is the much expanded footprint of the central clearing counterparties or CCPs as a result of the clearing mandate, and their interlocking relationships with their largest member organizations – the Global Systemically Important Banks or GSIBs.

This interconnected complex is far larger today than it was pre-crisis because of the clearing mandate and poses what is effectively a greatly expanded systemic risk to the U.S. and global financial systems.[5]

It is important to recognize that the premise of these central clearing counterparties is that the member banking organizations mutualize the risks of a member failure or an operational failure to the CCP. The obligations of the member banking organizations to the CCP go far beyond the collateral they may

[5] BCBS, CPMI, FSB, OICU-IOSCO, Analysis of Central Clearing Interdependencies, 9 August 2018 at https://www.bis.org/cpmi/publ/d181.pdf.

post for particular derivative exposures and their contributions to the guarantee fund of a CCP.

Ultimately, as part of the mutual arrangements of CCP members, the CCP may assess non-defaulting members potentially unlimited amounts that go far beyond a member's posted collateral and guarantee fund contributions. These mutualized risks are not currently accounted for in the capital rules. The leverage ratio capital requirements that large clearing member banking organizations currently must meet should not be reduced, making them even more vulnerable to these mutualized risks.

Industry has argued that the supplementary leverage ratio capital requirement that applies to the largest banking organizations has been an impediment to clearing. As the preamble to the final rule points out, "Commenters that supported greater recognition of client collateral argued that such an approach would be consistent with the G20 mandate to establish policies that support the use of central clearing for derivative transactions, as it could decrease the regulatory capital cost of providing clearing services and thereby improve access to clearing services for clients, reduce concentration among clearing member banking organizations, and improve the portability of client positions to other clearing members, particularly in time of stress."[6]

These concerns are misplaced. Clearing of standardized over-the-counter derivatives is now common practice. The focus should be on the financial stability risks posed by the growth of the central clearing counterparties and their interconnections with their large member banking organizations.

The membership of the CCPs is already dominated by the largest banking organizations. The benefits of reducing leverage capital will be overwhelmingly concentrated among the large existing member banks, not among smaller new entrants. If a clearing member fails and its derivative portfolio must be assumed by other clearing members, preemptively decreasing the capital of those other clearing members will not strengthen their capability to assume expanded responsibilities; it

[6] Final Rule: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts at 154 (footnote omitted).

would weaken it. Any consideration of capital adjustments, if needed at all, should be made at the time of failure.

In sum, the treatment of collateral for purposes of leverage capital held for derivatives positions by large member banking organizations with CCPs raises one of the most important financial stability issues of this post-crisis period. That leverage capital position should not be weakened. For that reason, I will vote against this final rule.