September 22, 2014

By electronic submission to www.fdic.gov

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Notice of Proposed Rulemaking – Deposit Insurance Assessment Calculation of Counterparty Exposure in the Highly Complex Institutions Scorecard

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (the "**FDIC**") Notice of Proposed Rulemaking (the "**Proposed Rules**")[2] regarding certain changes to the deposit insurance assessment calculation methodology. The FDIC indicates in the Preamble to the Proposed Rules that these changes are meant to bring the FDIC's deposit insurance assessments framework ("**Assessment Framework**") as implemented in the assessment rule currently in force (the "**Current Assessment Rule**")[3] more in line with the U.S. Basel III-based capital rules (the "**U.S. Basel III Capital Rules**") recently finalized by the Federal banking agencies.[4] Our

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively hold more than half of all U.S. deposits and employ over one million people in the United States and more than two million people worldwide. The Clearing House Association L.L.C. is a nonpartisan advocacy organization that represents the interests of its owner banks by promoting and developing policies to support a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions. It clears almost $2 trillion each day, representing nearly half of all automated clearing-house, funds transfer and check-image payments made in the United States. See The Clearing House's web page at www.theclearinghouse.org.

[2] 79 Fed. Reg. 42698 (July 23, 2014).

[3] 12 C.F.R. § 327. *See also* 76 Fed. Reg. 10672 (Feb. 25, 2011) for the FDIC's adopting release.

[4] The "U.S. Basel III Capital Rules" refer to those rules adopted by the Federal banking agencies that replace the agencies' Basel I-based, generally applicable risk-based capital rules. 78 Fed. Reg. 55340 (Sept. 10, 2013); 78 Fed. Reg. 62018 (Oct. 11, 2013); 79 Fed. Reg. 20754 (Apr. 14, 2014).

comments focus on the significant changes contemplated by the Proposed Rules to the calculation of counterparty exposure in the scorecard currently used to determine the deposit insurance assessments of highly complex insured depository institutions ("**HC-IDIs**").

The Clearing House supports the maintenance of a robust federal deposit insurance fund (the "**DIF**") under which assessments are determined on the basis of the statutory requirement of actual risk to the DIF.[5] Adherence to this actual risk criterion is essential for multiple reasons: it promotes the integrity of the DIF; it discourages excessive or undue risk-taking; it avoids subsidies; it is more fair; and it is consistent with the fundamental principles of insurance. In previous comment letters, we have expressed our view that the approach taken by the FDIC to implement the Assessment Framework is, in several crucial respects, inconsistent with the statutory requirement that the system be risk-based.[6] More particularly, the Current Assessment Rule distorts the analysis of risk to the DIF by addressing only "risk of failure" and failing to provide a comprehensive consideration of "risk of loss upon failure" and focuses risk-reduction efforts on large banks, despite the higher failure rate of small- and medium-sized banks.

We are concerned that the Proposed Rules could result in the Assessment Framework deviating yet further from this statutory mandate that assessments be based on actual risk to the DIF. Specifically, the Proposed Rules would fail to recognize the risk mitigation benefits of collateral, include central counterparties ("**CCP**") in the counterparty exposure measure, and eliminate the option to use an internal model methodology ("**IMM**") to measure counterparty exposure for the purpose of the concentration measure.

We are also concerned that the justification provided for the elimination of the IMM option is substantially flawed and, if these flaws are not addressed, may suffer from procedural defects. A key driver of the elimination of the IMM option appears to be that "the adoption of the IMM by itself will cause a significant reduction in counterparty exposure amounts and change the scorecard results in a way that significantly reduces deposit insurance assessments for the HC-IDIs using the IMM."[7] We are concerned that the Proposed Rules now seek to reverse the decision made by the FDIC as recently as 2011 in order to achieve a predetermined result without a sound analytical justification. The perceived drop in the insurance assessments may very well be the result of the more rigorous risk-based approach inherent in the IMM.

Although the Preamble to the Proposed Rules provides some additional bases for the FDIC's proposed change—*i.e.*, that the reduction is driven by measurement methodology rather

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[5] Section 7(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)) requires that the Assessment Framework be risk-based and that the risk have two essential components: (i) the potential of failure of a bank as reflected in the probability of loss due to the composition and concentration of the institution's assets and liabilities; and (ii) the likely amount of any loss on failure.

[6] *See* Letter from The Clearing House to the FDIC (Jan. 3, 2011), *available at* http://www.fdic.gov/regulations/laws/federal/2010/10c20AD66.pdf; Letter from The Clearing House to the FDIC (July 16, 2010), *available at* https://www.fdic.gov/regulations/laws/federal/2010/10c20AD57.pdf.

[7] 79 Fed. Reg. at 42703.

than a change in risk exposure of an institution and the fact that different HC-IDIs will have different methodologies[8]—these effects were evident at the time that the Current Assessment Rule was adopted and, more importantly, do not address the fundamental correlation between risk as a mandated driver for the assessments and the use of IMM as a risk-sensitive measure. As the Federal banking agencies have previously recognized, the core purposes of using IMM to measure counterparty risk is to recognize differences among HC-IDIs to allow for more precise measurement of risk[9] as a way to correct the known flaws of the so-called credit equivalent amount approach (and its corollary in the Basel II framework, the current exposure methodology)[10] that cause it to misstate risk. As such, the Proposed Rules' lack of an expressed and sound analytical justification for abandoning IMM in the face of the statutory mandate for risk sensitivity creates serious doubt as to whether the FDIC has met its obligations under the Administrative Procedure Act ("**APA**") to provide a "rational connection between the facts found and the choices made."[11] The Proposed Rules do not offer evidence for, or other rational basis or connection to support, the notion that IMM is not merely a more risk-sensitive measure that amply justifies a lower gross assessment amount.

Changes to the Assessment Framework should not be made based on whether assessments for any size class of banks increase or decrease, but rather whether they meet the purpose of the Assessment Framework—to assess IDIs on the basis of the risk they actually pose to the DIF. A return to the credit equivalent amount for those institutions that have devoted significant resources to developing IMMs in consultation with their supervisors and the inability to recognize the risk-mitigating benefits of collateral are a step backwards from an Assessment Framework that assesses institutions on the basis of risk.

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[8] *Id.*

[9] *See* 72 Fed. Reg. 69288, at 69291 ("This final rule is intended to produce risk-based capital requirements that are more risk-sensitive than those produced under the agencies' existing risk-based capital rules."). *See also* Basel Committee on Banking Supervision (the "**Basel Committee**"), *International Convergence of Capital Measurement and Capital Standards* (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf ("In developing the [Basel II advanced approaches framework], the [Basel] Committee has sought to arrive at significantly more risk-sensitive capital requirements.").

[10] The credit equivalent amount in the U.S. Basel I-based capital rules, the credit equivalent amount under the Standardized Approach, and the Basel Committee's Basel II current exposure method are all broadly similar. The U.S. Basel III Capital Rules generally retain the treatment of the OTC derivatives provided under the U.S. Basel I-based capital rules. This approach is similar to the current exposure method for determining the exposure amount for OTC derivative contracts contained in the Basel Committee's Basel II framework. The U.S. Basel III Capital Rules made minor revisions to the treatment of OTC derivative contracts, including updating the definition of an OTC derivative contract revising the conversion factor matrix for calculating potential future exposure ("**PFE**"), revising the criteria for recognizing netting benefits and financial collateral, and the removal of the 50 percent risk weight cap for OTC derivative contracts. *See* 78 Fed. Reg. at 55411 and 78 Fed. Reg. at 62094.

[11] *Motor Vehicle Manufacturers Association of the United States* v. *State Farm Mutual Automobile Insurance Co*., 463 U.S. 29, 43 (1983); *Business Roundtable* v. *SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

In addition, we are troubled by the Proposed Rules' approach to the cost-benefit analysis of implementing changes to the Assessment Framework.[12] The FDIC's own policy would require that a cost-benefit analysis of a rule be considered.[13] Given the FDIC's admission in the Preamble to the Proposed Rules that, at this time, it "lacks sufficient data to determine the magnitude of the increases [of the assessments]"[14] that would arise from the Proposed Rules, we do not see how the FDIC can comply with its policy with respect to these changes without delaying issuance of a final rule until the effects of these proposals can be properly measured and understood. We anticipate that the inability to recognize collateral in measuring counterparty exposure, the inclusion of all CCPs in the counterparty exposure measures, and the elimination of the IMM option will have a significant effect on the assessments for most, if not all, HC-IDIs. The FDIC should not move forward without first understanding the actual costs and benefits of the Proposed Rules.

Finally, given the potentially significant impact of the changes to the counterparty exposure measures in the Proposed Rules, we are concerned with the FDIC's reliance on its reservation of authority to recalibrate the conversion of the counterparty exposure measures to scores without notice and comment. Considerations such as the timing of the recalibration and the adjustments that may be made to compensate for the fact that sufficient data may not be available could have real consequences on HC-IDIs' assessments. Accordingly, we believe that, at least in this instance, notice and comment on the approach that would be taken to recalibrate the conversion of the counterparty exposure measures, and the timing of such recalibration, is critical to a transparent and fair process.

I. Executive Summary

The FDIC is statutorily mandated to maintain an Assessment Framework that is based on actual risk to the DIF. Given that the Current Assessment Rule already deviates from this risk-based mandate in order to accommodate the Tester Amendment,[15] the FDIC should avoid further changes to the Assessment Framework that exacerbate this deviation from its risk-based mandate. Specifically, the final rule should:

- **Recognize the credit risk mitigation benefits of financial collateral in the methodology for measuring counterparty exposure.** The Proposed Rules should permit recognition of collateral, consistent with the treatment of collateral under the Standardized Approach of the U.S. Basel III Capital Rules (the "**Standardized**

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[12] 79 Fed. Reg. at 42704 ("Because banks will not begin reporting under the [U.S. Basel III Capital Rules] until March 2015, the FDIC lacks sufficient data at this time to determine whether the proposals would increase or decrease total scores and assessment rates.").

[13] *See* discussion below in Section II.D. *See also* FDIC, *Statement of Policy on the Development and Review of FDIC Regulations and Policies*, No. 5157 (1998); Executive Order 13563 (Jan. 18, 2011); and Executive Order 13579 (July 11, 2011).

[14] 79 Fed. Reg. at 42704.

[15] In its previous comment letter regarding deposit insurance assessment base and rate and large bank pricing, The Clearing House extensively discussed the Tester Amendment and how it deviates from a risk-based Assessment Framework. *See supra* note 6.

Approach"), in light of the significant risk-reducing role of collateral in financial transactions.

- **Exclude qualifying central counterparties ("QCCPs")**[16] **from the counterparty exposure measures.** QCCPs should be excluded from the counterparty measure because the use of QCCPs is designed to reduce risk to both institutions and the broader financial system, as reflected in the clearing mandates introduced under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

- **Exclude affiliates and non-U.S. sovereigns from the counterparty exposure score.** Because of heightened, risk-reducing requirements for transactions between banks and their affiliates under Section 23A of the Federal Reserve Act and Regulation W, exposure to affiliates should not be included in the counterparty exposure measure. In addition, non-U.S. sovereigns that meet certain criteria used in the Standardized Approach should be excluded from the counterparty exposure measure, or, alternatively, criteria used to determine which non-U.S. sovereign obligations may be treated as Level 1 high-quality liquid assets ("**HQLA**") under the liquidity coverage ratio ("**LCR**").[17]

- **Retain the IMM option.** Because IMMs are risk-sensitive, they are a more appropriate measure of the risk of counterparty exposure than the credit equivalent amount. The FDIC should not eliminate the IMM option unless it can articulate how such elimination supports the Assessment Framework's risk-based mandate. Additionally, in evaluating alternatives to measuring counterparty exposure, at a minimum, the FDIC should not eliminate the IMM option until it is known how and whether the Basel Committee's Standardized Approach for Counterparty Credit Risk ("**SA-CCR**"), a more risk-sensitive measure of counterparty exposure than the credit equivalent amount, will be included in the U.S. Basel III Capital Rules.

- **Subject recalibration of the conversion of the counterparty exposure measures to notice and comment under the APA.** Because of the potentially significant impact of the proposed changes and uncertainty regarding approach to the recalibration, HC-IDIs should be afforded the opportunity to comment on the recalibration of the conversion of the counterparty exposure measure.

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[16] QCCPs are central counterparties that meet standards established by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions. *See* 78 Fed. Reg. at 62097 and 78 Fed. Reg. at 55414.

[17] *See* Office of the Comptroller of the Currency ("**OCC**"), Board of Governors of the Federal Reserve System ("**Federal Reserve**"), and FDIC, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards* (Sept. 3, 2014).

II. Discussion

A. Collateral Recognition

Any measure of counterparty exposure should recognize the credit risk mitigation benefits of financial collateral, as permitted in the Standardized Approach.[18] Failure to properly consider collateral in calculating potential future exposure is generally recognized as one of the flaws of the credit equivalent amount approach.[19] Collateral reduces the risk relating to future exposure an IDI may have to a counterparty through the duration of a derivative transaction and, therefore, it would be inappropriate not to take collateral into consideration in determining the size of a HC-IDI's counterparty exposures in a truly risk-based Assessment Framework. It is especially appropriate for the Assessment Framework to recognize the risk-reducing characteristics of collateral in light of the collateral requirements for both cleared and uncleared trades required by individual clearing houses[20] and Title VII of the Dodd-Frank Act,[21] respectively.[22]

[18] 12 C.F.R. §§ 3.34(b) and 3.37(a), 217.34(b) and 217.37(a), and 324.34(b) and 324.37(a) (stating that to recognize the risk-mitigating effects of financial collateral, a bank may use: (i) the simple approach or (ii) the collateral haircut approach for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions).

[19] *See* Basel Committee, *The standardised approach for measuring counterparty credit risk exposures* (March 2014), at 1, *available at* http://www.bis.org/publ/bcbs279.pdf ("The [current exposure amount] had been criticised for several limitations, in particular that it did not differentiate between margined and unmargined transactions, that the supervisory add-on factor did not sufficiently capture the level of volatilities as observed over recent stress periods, and the recognition of netting benefits was too simplistic and not reflective of economically meaningful relationships between derivatives positions."). *See also* Letter from The Clearing House, American Bankers Association, the Financial Services Roundtable, Financial Services Forum and SIFMA to the Federal Reserve (April 27, 2012), at C-4, *available at* http://www.federalreserve.gov/SECRS/2012/May/20120501/R-1438/R-1438_042712_107270_542775340448_1.pdf (stating that the "most significant flaw of [current exposure method]" is "its failure to appropriately take into account collateral and legally enforceable netting in the calculation of [PFE]"); The Clearing House, *Single Counterparty Credit Limits: The Clearing House Industry Study* (July 2012), at 6, *available at* http://www.federalreserve.gov/newsevents/rr-commpublic/tch-letter-and-study-20120719.pdf (submitted to the Federal Reserve on July 19, 2012).

[20] CCPs require that their counterparties post specific initial margin and variation margin on trades. Variation margin is typically settled via a cash payment in the relevant currency and CCPs generally only permit clearing members to post high-quality and liquid collateral as initial margin. Although a CCP does not post initial margin to its clearing members, in the event of a default by a clearing member, the CCP will use the initial margin of the defaulter to satisfy amounts owed to its non-defaulting clearing members.

[21] Section 731 of the Dodd-Frank Act, which adds a new Section 4s to the Commodities Exchange Act ("**CEA**"), explicitly requires the adoption of rules establishing margin requirements on uncleared swaps for swap dealers ("**SDs**") and major swap participants ("**MSPs**"). It requires that each SD and MSP subject to supervision by a prudential regulator meet margin requirements established by the applicable prudential regulator. Each SD or MSP that has no prudential regulator must comply with Commodity Futures Trading Commission ("**CFTC**") regulations governing margin. *See also* S. Rep. 11-176, at 33 (2010) ("While large losses are to be expected in derivatives trading, if those positions are fully margined there

The following example demonstrates that the Proposed Rules depart from a risk-based formulation. Assume that two banks have entered into the same, substantially in-the-money, derivative contract with a counterparty that subsequently began to experience financial difficulty. The counterparty's exposure to the first bank is collateralized; the counterparty's exposure to the second bank is not. Contrary to any realistic assessment of risk, the Proposed Rules would treat the two banks as having identical exposure.

Because the Standardized Approach permits a HC-IDI to recognize the risk-mitigating effect of financial collateral when calculating derivative counterparty exposure,[23] counterparty exposures will be included in a HC-IDI's capital reporting on that basis. In addition to the substantive issues raised above, the FDIC would be acting contrary to the assertion in the Preamble to the Proposed Rules that the proposal would "not impose additional reporting burdens" if it determines not to recognize risk-reducing collateral in calculating counterparty exposure under the Assessment Framework.[24] In fact, IDIs report derivative counterparty exposure taking collateral into account. As a result, the proposed approach would impose reporting complexities and burdens for HC-IDIs, as they would need to generate separate reports solely for assessment purposes. Furthermore, failing to recognize the risk-mitigating effect of collateral is in conflict with the FDIC's desire to bring the Assessment Framework more in line with the U.S. Basel III Capital Rules.

B. Counterparties Included in Counterparty Exposure Score

1. Qualifying Central Counterparties

QCCPs should be excluded as counterparties in the concentration measures. In light of the increased role of CCPs as a result of clearing mandates introduced in Title VII of the Dodd-Frank Act,[25] inclusion of CCPs as counterparties for purposes of the concentration measure will

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will be no loss to counterparties and the overall financial system and none of the uncertainty about potential exposures that contributed to the panic in 2008.").

[22] We acknowledge the fact that the enhanced supplementary leverage ratio ("**SLR**") adopted by the OCC, Federal Reserve, and FDIC does not take collateral into account when calculating PFE. *See* 79 Fed. Reg. 24596, 24598 (May 1, 2014) ("For purposes of determining total leverage exposure, a banking organization would not be permitted to reduce the PFE by the amount of any collateral under section 34(b) of the 2013 revised capital rules."); OCC, Federal Reserve, and FDIC, *Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio* (Sept. 3, 2014), at 36-37. SLR, however, is by definition not supposed to be risk-based, while, as discussed at length in this letter, the Assessment Framework is statutorily required to be based on actual risk to the DIF. Therefore, the different treatments of collateral under the SLR and Assessment Framework are not only justified but required by statute.

[23] *See supra* note 18.

[24] 79 Fed. Reg. at 42704.

[25] *See* 7 U.S.C. § 50.2(a). Title VII of the Dodd-Frank Act amended the CEA by requiring a swap to be cleared through a CCP if the CFTC determined that the swap, or group, category, type, or class of swap, is required to be cleared, unless an exception to the clearing requirement applies. To date, the CFTC has determined that certain credit default swaps and interest rate swaps must be cleared. Required central clearing of derivative transactions has also been a major component of international regulatory reform as

skew the measure and increase assessments for many IDIs in a way that is not correlated to the risk posed to the IDIs. Indeed, the FDIC's proposed approach contravenes Congress' mandate. Congress encouraged use of QCCPs to reduce risk; the Proposed Rules discourage use of QCCPs by effectively increasing the risk assessment if they are actually used as mandated. Central clearing is, therefore, a key element of financial reform precisely because it is meant to reduce risk to the institutions and to the financial system more broadly. With appropriate collateral and margin requirements, CCPs can "substantially reduce counterparty risk"[26] and serve as an important mitigant of systemic risk.[27] Accordingly, increased use of CCPs should not give rise to a higher assessment in a risk-based Assessment Framework, and HC-IDIs should not be penalized for use of CCPs as Congress mandates that they do.

The scorecard in the Current Assessment Rule takes into account how large a HC-IDI's top counterparty exposures are relative to its Tier 1 capital, and large exposures to top counterparties will result in a HC-IDI having a higher score for those concentration measures, and, as a result, most likely a higher base assessment rate.[28] Mandatory clearing and preferential risk weightings for regulatory capital purposes for certain cleared transactions, as compared to bilateral OTC derivative transactions, will drive a significant amount of derivatives activity to CCPs.[29] Because certain CCPs are already the largest counterparties for many HC-IDIs as a result of these initiatives, and, over time, will likely come to dominate the top 20 counterparty lists at those institutions as more trades are subject to mandatory clearing, inclusion of CCPs will almost certainly increase the concentration measure scores for many HC-IDIs.

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a means of reducing risk in the financial system. *See* Leaders' Statement for the 2009 G20 Summit on Financial Markets and the World Economy, *available at* http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf (seeking the implementation of central clearing by the end of 2012).

[26] *See* S. Rep. 11-176, at 33 (2010) (continuing, "While large losses are to be expected in derivatives trading, if those positions are fully margined there will be no loss to counterparties and the overall financial system and none of the uncertainty about potential exposures that contributed to the panic in 2008.").

[27] *See* 78 Fed. Reg. at 55414 and 78 Fed. Reg. at 26096 ("The [Basel Committee] and the [Federal banking] agencies support incentives designed to encourage clearing of derivatives and repo-style transactions through a CCP wherever possible in order to promote transparency, multilateral netting, and robust risk-management practices . . . the [Federal banking] agencies believe that CCPs generally help improve the safety and soundness of the derivatives and repo-style transactions markets through the multilateral netting of exposures, establishment and enforcement of collateral requirements and the promotion of market transparency.").

[28] The score for "Concentration Measure" for HC-IDIs is the greatest of: (i) the Higher-risk Assets/Tier 1 Capital and Reserves; (ii) Top 20 Counterparty Exposure/Tier 1 Capital and Reserves; and (iii) Largest Counterparty Exposure/Tier 1 Capital and Reserves.

[29] Under U.S. Basel III Capital Rules, a 2% risk weight is assigned to exposure amounts related to transactions cleared with a QCCP, while there are increasing risk weights, and, therefore, regulatory capital requirements, for exposures to non-CCP counterparties, thus making it more expensive for banks to enter into bilateral OTC derivatives transactions. *See* 78 Fed. Reg. at 55418 and 78 Fed. Reg. at 62100.

In light of the capital and other prudential requirements to which QCCPs are subject,[30] QCCPs should be excluded from the counterparty exposure measure. The rigorous requirements that apply to QCCPs will ensure that only exposures to sound and stable counterparties—counterparties that are not likely to expose the institution, and, by extension, the DIF, to significant additional risk—would be excluded from the concentration measure.

At a minimum, exclusion of QCCPs for a transition period, until the full impact of the central clearing requirements is known and the strength of QCCPs can be more fully understood, is appropriate. This would be consistent with the treatment of QCCPs under the Basel Committee's "Supervisory framework for measuring and controlling large exposures," under which QCCPs will be excluded for an observation period that runs until 2016, while the Basel Committee reviews whether QCCP exposures should be subject to the large exposure limit.[31]

2. Other Counterparties

Because they do not meaningfully increase risk to the DIF, exposure to affiliates and certain non-U.S. sovereigns should be excluded from the counterparty exposure measure.

Affiliates. Exposure of a HC-IDI to its affiliates should be excluded from the counterparty exposure measure in recognition of the statutory framework that governs such affiliate transactions. Section 23A and Regulation W limit the amount of "covered transactions" between a bank and its affiliates.[32] "Covered transactions" include the purchase of assets by a bank from its affiliates and a bank's extensions of credit to its affiliates.[33] Section 23A and Regulation W also require a bank to secure its extensions of credit to its affiliates with prescribed amounts of collateral.[34]

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30 QCCPs are subject to stringent standards, including a requirement that the QCCP "is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the QCCP on an ongoing basis, domestic rules and regulations that are consistent with the [Committee on Payment and Settlement Systems – International Organization of Securities Commissions] Principles for Financial Market Infrastructures." Basel Committee, *Capital Requirements for bank exposures to central counterparties* (July 2012), at 1, *available at* http://www.bis.org/publ/bcbs227.pdf.

31 *See* Basel Committee, *Supervisory framework for measuring and controlling large exposures* (April 2014), *available at* http://www.bis.org/publ/bcbs283.pdf.

32 *See* Federal Reserve Act, Section 23A(a)(1) (12 U.S.C. § 371c(a)(1)) and Regulation W (12 C.F.R. §§ 223.11 and 223.12). Section 23A imposes quantitative limits of 10% of the bank's capital stock and surplus on a bank's transactions with one affiliate and 20% of the bank's capital stock and surplus on a bank's transactions with all affiliates.

33 *See* Federal Reserve Act, Section 23A(b)(7) (12 U.S.C. § 371c(b)(7)).

34 *See* Federal Reserve Act, Section 23A(c)(1) (12 U.S.C. § 371c(c)(1)) and Regulation W (12 C.F.R. § 223.14), require that transactions with affiliates be secured by collateral ranging from 100% (for obligations of and guaranteed by the United States and its agencies) to 130% (for collateral that is stock, lease, or other real person property) of the amount of the transaction.

As amended by the Dodd-Frank Act, Section 23A now explicitly includes credit exposure from derivative transactions between an IDI and its affiliate as an extension of credit that is a covered transaction.[35] Accordingly, credit exposure to an affiliate from derivative transactions is not only limited in amount but also is subject to other requirements, that will be further defined by the Federal Reserve by regulation. Similarly, the Dodd-Frank Act amendments also clarify that securities repurchase transactions and securities borrowing and lending transactions are covered transactions under Section 23A.[36]

As more activity is concentrated in CCPs and HC-IDIs have fewer counterparties, affiliates almost certainly will be among some HC-IDIs' top 20 counterparties list, even if the HC-IDI does not increase the amount of its derivatives transactions with its affiliates. Given that affiliates will become larger counterparties for HC-IDIs without necessarily any increase in actual exposure and that transactions between a bank and its affiliates are subject to comprehensive safeguards, such transactions should not increase risk to the DIF. Accordingly, it is appropriate to exclude affiliates as counterparties from the concentration measure.

Non-U.S. Sovereigns. Any final rule issued by the FDIC should exclude certain non-U.S. sovereigns with high credit quality from the counterparty exposure measure. In calculating the counterparty exposure score, the Proposed Rules would exempt exposures to the U.S. government, but provide no similar exemption for exposure to non-U.S. sovereigns that have comparable credit quality and obligations that are highly liquid.

We recognize that the mechanisms for distinguishing among non-U.S. sovereigns are imperfect. Nonetheless, the U.S. regulatory agencies, including the FDIC, have developed criteria in other regulatory contexts for determining which non-U.S. sovereigns should be treated the same as the United States. For purposes of the concentration measure, non-U.S. sovereigns should be excluded based on the measures that are used for regulatory capital requirements under the Standardized Approach for purposes of determining risk-weighted assets. Under the Standardized Approach, foreign sovereign exposures are assigned risk weights based on either the Organization for Economic Cooperation and Development's ("**OECD**") Country Risk Classification ("**CRC**") applicable to the sovereign or the sovereign's OECD membership status if there is no CRC applicable.[37] Similarly, non-U.S. sovereigns with a risk-weight of zero, and who are full members of the OECD, should not be included in the calculation of counterparty exposure for assessment purposes, as exposure to such sovereigns generally should present little risk to an IDI, and, thus, little risk to the DIF.

If there is a concern that those criteria may be over-inclusive, another alternative would be to exclude from the counterparty exposure measure non-U.S. sovereigns that meet additional requirements that are consistent with the criteria used to determine which obligations may be included as Level 1 HQLA under the LCR recently adopted by the Federal banking agencies. Although the context is not precisely analogous, certain of the criteria may address concerns regarding the scope of sovereigns that may be included under the

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35 *Id*.

36 *See* Federal Reserve Act, Section 23A(b)(7) (12 U.S.C. § 371c(b)(7)).

37 *See* 12 C.F.R. §§ 3.32(c)(3), 217.32(c)(3), and 324.32(c)(3).

Standardized Approach. The requirement that a non-U.S. sovereign's securities must have a proven record as a reliable source of liquidity in the repurchase or sales markets during stressed market conditions may be useful to address concerns. As noted in the LCR adopting release, Level 1 HQLA have the highest potential to generate liquidity for a covered company during periods of severe liquidity stress[38] and present the least exposure to counterparties. The LCR adopting release also noted that the additional criteria for Level 1 HQLA limit concerns "that capital risk weight alone is insufficient to preclude all illiquid foreign debt issuances,"[39] and, in this context, could address related concerns regarding the risk posed by the exposure to the particular sovereign.

C. Elimination of the IMM Option

Elimination of the IMM option is premature and should only be undertaken in a considered, procedurally sound manner in which it can be demonstrated why the elimination of the IMM option is consistent with the Assessment Framework's risk-based mandate.

The shortcomings of the credit equivalent approach, which the Proposed Rules would substitute, as a measure of the risk associated with counterparty exposure are well known and have been widely recognized,[40] as reflected in the Basel Committee's development of an alternative approach to measuring counterparty credit risk for derivative exposures, the SA-CCR.[41] The Proposed Rules, nonetheless, would abandon the option to measure counterparty exposure using IMMs—models that are specifically designed to measure actual risk—in favor of the credit equivalent approach—with far less correlation risk—in an Assessment Framework that is specifically mandated to be risk-based.[42]

The Preamble to the Proposed Rules provides no rationale for why or how measuring counterparty exposure under the credit equivalent amount is more consistent with a risk-based mandate than doing so using IMMs, and the absence of any such discussion is telling.[43] The FDIC

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[38] *See* OCC, Federal Reserve, and FDIC, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, at 59.

[39] OCC, Federal Reserve, and FDIC, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, at 67.

[40] *See supra* note 19.

[41] *See* Basel Committee, *The standardised approach for measuring counterparty credit risk exposures*, *supra* note 19. The SA-CCR, which will replace both the Current Exposure Model and the Standardized Method, presents a new framework for calculating PFE.

[42] The FDIC also has requested comment on whether "total leverage exposure" might be an alternative to measure counterparty exposure. It is generally recognized that a leverage measure is attractive as a backstop because it is not risk-based, and thus, could act as a safety valve in the event risk-based measures failed. *See* Basel Committee, *Basel III: a global regulatory framework for more resilient banks and banking systems* (June 2011), at ¶ 152, *available at* http://www.bis.org/publ/bcbs189.pdf (recognizing that the leverage ratio is not risk-based). The very fact that it is not risk-based, however, would make it an inappropriate measure in the Assessment System context.

[43] The Preamble to the Proposed Rules notes that the elimination of IMM would result in all HC-IDIs calculating their counterparty exposure using a common measurement framework. We do not believe

cites as a basis for eliminating the IMM that its use will cause significant reductions in counterparty exposure measure amounts in a way that significantly reduces deposit insurance assessments for the HC-IDIs using the IMM but does not attribute this result to a change in risk exposure.[44] The Proposed Rules do not address the debate regarding the shortcomings of the credit equivalent approach and fail to acknowledge that the reduction in counterparty exposure scores can be explained—perhaps most persuasively—by the likelihood that IMMs more accurately measure counterparty exposure risk, and that any resulting decline in insurance assessments is warranted because counterparty risk is lower than the estimate produced by the credit equivalent approach. In other words, the potential that the credit equivalent approach overstates the actual risk, and, thus, results in assessments that are excessively high, is ignored.

In implementing an Assessment Framework that is required by statute to be risk-based, the Proposed Rules' justification for supporting the elimination of the IMM option amounts to a failure to provide a "rational connection between the facts found and the choices made," such that the Proposed Rules, if finalized on this basis, would fail to meet APA requirements.[45] To meet APA requirements, the rules should, at a minimum, be re-proposed in a manner that articulates an analytically sound basis for eliminating the IMM option in light of a connection between the risk-based mandate and the IMM's risk sensitivity. This is required to provide the public with a meaningful opportunity to comment, consistent with the APA.[46]

Finally, even if a return to a standardized, as opposed to an internal model, method of estimating counterparty exposure can be justified on a risk-based analysis, adopting the proposed approach for purposes of the Assessment Framework at this time is premature. As noted, the Basel Committee recently finalized the SA-CCR, an approach designed to replace the current exposure methodology within the Basel III framework. In adopting the U.S. Basel III Capital Rules, the Federal banking agencies noted that they are aware of the ongoing work of the Basel Committee to improve the current exposure methodology and "expect to consider any necessary changes to update the exposure amount calculation when the [Basel Committee] work [is] completed."[47] Given the release of the final SA-CCR, the FDIC at a minimum should

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that mere conformity is a valid argument for dispensing with the IMM approach. Indeed, an appraisal that homogenizes the calculation of exposure is directly contrary to a risk-based exposure calculation. If certain HC-IDIs choose to go through the rigor and expense of adopting a more accurate measure of their counterparty risk, the results should not be discarded because other HC-IDIs have not. Banks may also use IMM to measure derivative exposure and securities financing transition exposure for purposes of the national bank lending limit. *See* 12 C.F.R. §§ 32.9(b)(1)(i) and 32.9(c)(1)(i).

[44] 79 Fed. Reg. at 42703 ("This significant reduction in assessments does not appear to be driven primarily by a change in risk exposure, but rather by a change in measurement methodology.").

[45] *State Farm*, 463 U.S. at 43; *Business Roundtable*, 647 F.3d at 1148.

[46] *See Appalachian Power Co*. v. *EPA*, 249 F.3d 1032, 1039 (D.C. Cir. 2001); *Chamber of Commerce of the United States* v. *SEC*, 443 F.3d 890, 900 (D.C. Cir. 2006) ("By requiring that 'most critical factual material' used by the agency be subjected to informed comment, the APA provides a procedural device to ensure that agency regulations are tested through exposure to public comment, to afford affected parties an opportunity to present comment and evidence to support their positions, and thereby to enhance the quality of judicial review.").

[47] 78 Fed. Reg. at 55412; 78 Fed. Reg. at 62094.

refrain from eliminating the IMM option until it is determined whether and how the SA-CCR will be incorporated into the U.S. Basel III Capital Rules.

D. Cost-Benefit Analysis

The Proposed Rules should not be finalized until their impact on the deposit insurance assessments of HC-IDIs—and particularly the elimination of the IMM option and inclusion of CCPs as counterparties—is known such that a cost-benefit analysis can be conducted that would be subject to public comment. The Preamble to the Proposed Rules asserts that the FDIC lacks sufficient data to determine the magnitude of the increase in assessments that would result from the elimination of the IMM option for calculating counterparty exposure. This appears to constitute a failure by the Proposed Rules to meet the terms of FDIC policy, which states that prior to issuance of a final rule, "the potential benefits associated with the regulation are weighed against the potential costs. Both the proposed and final rule should discuss key implications that the FDIC considered in its analysis."[48] It also would be inconsistent with U.S. government policy that an analysis and "reasoned determination" regarding the costs and benefits of a proposed rule, including the "costs of cumulative regulations," and the consideration of less burdensome alternatives should be conducted.[49]

We do not see how a cost-benefit analysis can be undertaken without additional data that will only become available over time.[50] Accordingly, we believe the appropriate course is to forego immediate changes to the Assessment Framework, the costs of which cannot be known until additional data becomes available and can be evaluated, and comment on a re-proposal of the Proposed Rules.

E. Recalibration

To ensure a fair and transparent process, any recalibration of the conversion of the counterparty exposure measures to risk assessment scores should be subject to notice and comment under the APA. As discussed, the Proposed Rules include significant changes to the measurement and components of the counterparty exposure measures. Although we recognize that there may eventually be a need for recalibration to reflect new data, it is not clear how and when the recalibration would be undertaken in this circumstance, which may have a meaningful impact on IDIs' assessments.

In the Current Assessment Rule adopting release, the FDIC reserved the right to update the minimum and maximum cut-off values used in each scorecard annually without further

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48 FDIC, *Statement of Policy*, *supra* note 13.

49 Executive Order 13563, January 18, 2011. Executive Order 13579, July 11, 2011, states that independent regulatory agencies, such as the FDIC, should comply with the cost-benefit analysis and regulatory burden reduction requirements of Executive Order 13563.

50 Information that will be provided in response to Call Report changes in the first quarter of 2015 will allow the FDIC to consider more fully the costs and benefits of the Proposed Rules.

notice and comment, as long as the method of selecting cut-off values remains unchanged.[51] The Proposed Rules again reserve this recalibration right. Given the proposed changes, however, this approach leaves open a variety of important questions, including:

- *Methodology*. The FDIC has stated that it would provide for notice and comment if it wished to change the methodology for selecting cut-offs, as opposed to just adjusting the cut-offs themselves using the same methodology as in the past. The HC-IDI scorecard measure at issue here, namely counterparty exposure, does not follow the typical 10th and 90th percentile value cut-offs because it contains two of the three measures that are not also used in the large bank scorecard. Instead, the cut-offs were assigned based on "recent experience" with no elaboration.[52] Thus, there is already little transparency surrounding how the FDIC determines the cut-offs for such measures. In addition, the line between simple recalibration and changes to the recalibration methodology may be hard to discern when unspecified measures, such as recent experience, are used in place of data, which weighs in favor of providing notice and opportunity for meaningful public comment.

- *Timing of the recalibration relative to availability of new data*. The FDIC does not specify when it would seek to recalibrate the scorecard. Depending on when it chooses to do so, the results of such recalibration will depend significantly on the amount of data then available. For example, assuming the rules are implemented as proposed, if the FDIC recalibrates immediately, it would likely not have sufficient data to consider adequately the effects of including CCPs in the counterparty exposure calculation. As a result, the FDIC would either need to base the recalibration on estimates of the counterparty exposure measures of HC-IDIs to take account of CCPs or base it on historical data that would not reflect the increase in concentration to CCPs that results from mandatory clearing. In contrast, if the FDIC does not recalibrate immediately, the inclusion of CCPs will inflate these institutions' scorecard concentration measure and, in turn, their overall score, even though moving trades to CCPs is consistent with prudent risk management and statutory mandates.

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[51] 76 Fed. Reg. at 10700. In October 2012, the FDIC reiterated this right, and anticipated that it would be necessary to employ such recalibration authority, when it adopted a rule amending the definition of "higher-risk assets to Tier 1 capital and reserves." 77 Fed. Reg. 10672, 66012-13 (Oct. 31, 2012).

[52] Scorecard measures generally are obtained by collecting the relevant data for the HC-IDIs subject to the measure for a historical period and then assigning minimum and maximum cut-off values—that is, a minimum score of zero or maximum score of 100—based on that data. In general, the minimum and maximum cut-off values are equal to the 10th and 90th percentile values for each measure in the scorecard among these institutions, over a 10-year period. 76 Fed. Reg. at 10695. For the three measures used in the HC-ICI scorecard that are not used in the scorecard for other large institutions, including "Top 20 Counterparty Exposure/Tier 1 Capital and Reserves" and "Largest Counterparty Exposure/Tier 1 Capital and Reserves," the FDIC does not use the 10th and 90th percentile values as cut-offs due to lack of historical data. Cut-offs for these measures are based partly upon the FDIC's "recent experience," and the maximum cut-offs range from approximately the 75th through 78th percentile of these values among only highly complex institutions. *Id*.

- *Limits on availability of historical data*. The FDIC has previously noted that there is limited data available for determining cut-off scores for the three measures specific to the HC-IDI scorecard.[53] As discussed in the Preamble to the Proposed Rules, the FDIC also does not have data relating to the effects of the Proposed Rules, which indicates that the data that would be necessary to recalibrate also is not currently available. In reserving authority to recalibrate, however, the Proposed Rules do not explain what, if any, steps the FDIC will take to compensate for that lack of data. As mentioned above, assuming the Proposed Rules are adopted as written and the cut-offs are not recalibrated, the inclusion of CCPs in the counterparty exposure measure likely will increase assessment scores for all HC-IDIs as a result of mandatory clearing (that is, all HC-IDIs will have higher concentration exposures to CCPs). It will be difficult, however, for the FDIC to gather accurate historical data, as each year more transactions will be driven into CCPs given clearing mandates. In light of the absence of historical data, the FDIC should explain, through a rulemaking or guidance that is subject to notice and comment, how it would recalibrate, including a description of any estimate or experience it may rely on, given that it may not be able to collect sufficient historical data.

In light of these substantial uncertainties and open questions, providing notice and comment is critical for IDIs to have a full understanding of the process and an opportunity to raise concerns in a meaningful way.

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Thank you for considering the views expressed in this letter. We appreciate the opportunity to share our views and would be pleased to discuss any of them further at your convenience. If you have any questions, please contact John Court at (202) 649-4628 (email: john.court@theclearinghouse.com).

Respectfully Submitted,

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[53] *See* 76 Fed. Reg. at 10695, fn. 69.