February 17, 2015

Mr. Robert DeV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
RIN 7100-AE 24
Regulation Q; Docket No. R-1502

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AE12

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
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RIN 1557-AD88
Docket ID OCC-2014-0025

Re: Regulatory Capital Rules: Regulatory Capital, Proposed Revisions Applicable to Banking Organizations Subject to the Advanced Approaches Risk-Based Capital Rule

Sir or Madam:

Better Markets[1] appreciates the opportunity to comment on the above-captioned joint proposed rule ("Proposed Rule") of the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve ("Board"), and the Federal Deposit Insurance Corporation ("FDIC").

INTRODUCTION AND SUMMARY OF COMMENTS

On September 13, 2013, the FDIC published an interim final rule, with request for comment, entitled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighting Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Interim Final Rule."[2] A joint final rule with the same title was published by the OCC and the Board on

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

[2] 78 FR 55340 (Sept. 10, 2013).

October 11, 2013.[3] On April 14, 2014, the FDIC published its final rule with the above mentioned title ("Final Rule").[4]

The above rules focus on three general topics:

1. Implementation of the Basel III capital framework;

2. Implementation of the updated standardized approach for risk-weighted assets; and

3. Implementation of the advanced approaches risk-based capital rules.

The Proposed Rule would clarify and update the above final rules in light of revisions to other relevant rules, and it would make technical corrections to the previously issued final rules. In particular, the Proposed Rule would revise the definition of residential mortgage exposure; clarify the disclosure requirements for advanced approaches banking organizations[5] regarding internal and external ratings and how those ratings interact with each other; revise the weighting methodology for covered positions; clarify the definition of a cleared transaction and the risk weights for certain client-cleared transactions; explain the application and disclosure of the supplementary leverage ratio and exposure at default[6] adjustment for recognized credit valuation adjustment; and amend the margin requirements for specific cleared transactions and procedures for using internal models and adjusting the fair value of liabilities.

This comment letter focuses on two aspects of the Proposed Rule:

- the proposal to permit clearing member banking organizations to assign a zero percent risk weight to the trade exposure amount of a cleared transaction[7] when a clearing member banking organization does not guarantee the performance of the central counterparty ("CCP") and has no payment obligation to the clearing member client in the event of a CCP default; and

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3 78 FR 62018 (Oct. 11, 2013).

4 78 FR 20754 (Apr. 14, 2014).

5 Advanced approaches banking organizations generally are those with consolidated total assets of at least $250 billion or consolidated total on-balance sheet foreign exposures of at least $10 billion. Market risk banking organizations generally are those with aggregate trading assets and trading liabilities equal to at least 10 percent of quarter-end total assets or $1 billion. Board of the Governors of the Federal Reserve, June 7, 2012.

6 For a risk weight derived from the IRB framework to be transformed into a risk weighted asset, it needs to be attached to an exposure amount. This can be seen as an estimation of the extent to which a bank may be exposed to a counterparty in the event of, and at the time of, that counterparty's default. In many banks' internal credit systems, this is expressed as estimated exposure at default (EAD). Bank for International Settlements, The Internal Ratings-Based Approach.

7 A transaction that is cleared by a CCP.

- the proposal to exempt cleared transactions that are part of a netting set[8] subject to a collateral agreement that exceeds 5,000 trades at any time during the previous quarter from the twenty business day margin-period-of-risk[9] in the internal models methodology.

This comment letter encourages the agencies to undertake an empirical analysis of the recovery and resolution regime for CCPs and the impact of that regime on the clearing members' exposure to CCPs for cleared transactions. This is necessary to determine the empirical evidence for and against exempting those products from the two percent risk weight, as provided for in the Final Rule. The comment letter also suggests that agencies need to conduct a study of liquidity premiums for large netting sets during normal and stress times to determine their eligibility for exemption from the twenty business day margin-period-of-risk requirement.

The above two provisions in the Proposed Rule are based on assumptions about the operations and recovery and resolution mechanisms for CCPs and the liquidity qualities of large netting sets. The comment letter acknowledges that those assumptions can be true in the best case scenario. However, those assumptions many not hold in a worst or even most-probable case scenario of multiple-institution failure or a system-wide shock. The comment letter discusses why a two percent risk weight to the trade exposure amount for a cleared transaction should be a universal minimum. The comment letter further discusses why that risk weight should be supplemented with mandatory minimum risk weights to account for clearing member exposures, including potential obligations to contribute to CCP guarantee funds, CCP claims, and capital calls.

The comment letter explains that irrespective of immediate guarantees provided by a clearing member, all cleared transactions within a clearing house enjoy an unlimited guarantee by the clearing house members. That means that whether a clearing member provides a guarantee for a transaction or not is irrelevant in the long run because all the positions in a clearing house are guaranteed by the clearing members. That is the key concept of mutualizing credit risk that made clearing houses attractive for risk management purposes.

The comment letter also challenges the assumption in the Proposed Rule that "a large netting set of cleared transactions would not require a lengthy period to close out in the event of a default of the CCP"[10] in all economic conditions. The letter proposes a conservative approach to the liquidity risk premium for large netting sets of cleared transactions, to ensure that the Board and the FDIC have sufficient regulatory resources to successfully undertake recovery and resolution activities if a counterparty and/or a CCP fail. The comment letter explains that in case of a CCP default, the liquidity of those sets is

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8 Netting set refers to a group of transactions with a single counterparty which are subject to legally enforceable netting arrangement.

9 Margin-period-of-risk refers to the time from the latest exchange of collateral covering a netting set until the defaulting counterparty's position is closed out and then re-hedged.

10 Proposed Rule, at 18.

uncertain and the liquidity premium can be substantial. A high liquidity premium may have a material negative affect on CCP resolution and recovery efforts by the Board and the FDIC and may impose additional costs on them.

COMMENTS

A two percent risk weight to the trade exposure amount for a cleared transaction should be a universal minimum, and it should be supplemented with mandatory minimum risk weights for clearing member exposures, including potential obligations to contribute to CCP guarantee funds, CCP claims, and capital calls.

To establish the risk weight for certain client-cleared transactions, the Proposed Rule refers to the regulatory capital framework, which assigns a two percent risk weight to the trade exposure amount for a cleared transaction with a qualifying central counterparty ("QCCP") and a risk weight according to section 32 of the regulatory capital framework to its trade exposure amount for a cleared transaction with a CCP that is not a QCCP.[11]

To calculate risk-weighted assets for a cleared transaction, a bank that is a clearing member must multiply the trade exposure amount for the cleared transaction by the risk

[11] Qualifying central counterparty (QCCP) means a central counterparty that:
(1)(i)Is a designated financial market utility (FMU) under Title VIII of the Dodd-Frank Act;
(ii) If not located in the United States, is regulated and supervised in a manner equivalent to a designated FMU; or
(iii) Meets the following standards:
(A) The central counterparty requires all parties to contracts cleared by the counterparty to be fully collateralized on a daily basis;
(B) The FDIC-supervised institution demonstrates to the satisfaction of the FDIC that the central counterparty:
(1) Is in sound financial condition;
(2) Is subject to supervision by the Federal Reserve, the CFTC, or the Securities Exchange Commission (SEC), or, if the central counterparty is not located in the United States, is subject to effective oversight by a national supervisory authority in its home country; and
(3) Meets or exceeds the risk-management standards for central counterparties set forth in regulations established by the Federal Reserve, the CFTC, or the SEC under Title VII or Title VIII of the Dodd-Frank Act; or if the central counterparty is not located in the United States, meets or exceeds similar risk-management standards established under the law of its home country that are consistent with international standards for central counterparty risk management as established by the relevant standard setting body of the Bank of International Settlements; and
(2)(i) Provides the FDIC-supervised institution with the central counterparty's hypothetical capital requirement or the information necessary to calculate such hypothetical capital requirement, and other information the FDIC-supervised institution is required to obtain under §§ 324.35(d)(3) and 324.133(d)(3);
(ii) Makes available to the FDIC and the CCP's regulator the information described in paragraph (2)(i) of this definition; and
(iii) Has not otherwise been determined by the FDIC to not be a QCCP due to its financial condition, risk profile, failure to meet supervisory risk management standards, or other weaknesses or supervisory concerns that are inconsistent with the risk weight assigned to qualifying central counterparties under §§ 324.35 and 324.133.
(3) Exception. A QCCP that fails to meet the requirements of a QCCP in the future may still be treated as a QCCP under the conditions specified in § 324.3(f).

weight appropriate for the cleared transaction. The exposure amount for the derivative contract, or netting set of derivatives contracts, is calculated using the methodology used to calculate exposure amounts for OTC derivative contracts, plus the fair value of the collateral posted by the clearing member client and held by the CCP, clearing member, or custodian in a manner that is not bankruptcy remote. For a cleared transaction that is a repo-style transaction or netting set of repo-style transactions, the trade exposure is calculated as the sum of the current fair value of all instruments, gold, and cash the bank has lent, sold subject to repurchase, or posted as collateral to the counterparty under the transaction (or netting set).

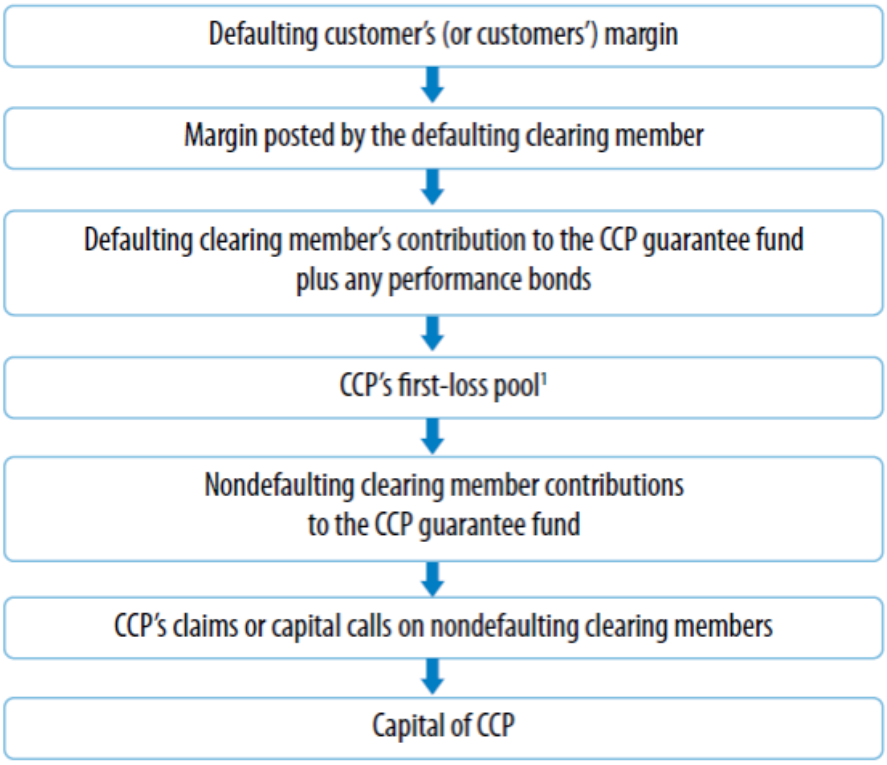
The Proposed Rule would permit member banking organizations to assign a zero percent risk weight to the trade exposure amount of a cleared transaction that arises when a clearing member banking organization does not guarantee the performance of the CCP and has no payment obligation to the clearing member client in the event of a CCP default.

To be able to evaluate this proposal, it is important to understand the governance and loss-sharing arrangements of CCPs as well as to understand the process and sequence of losses in case of a CCP failure. The Proposed Rule assumes that if a bank as a clearing member does not guarantee the client position, it should not be subject to the capital treatment. This also assumes that a bank's exposure is limited to a particular contract exposure, which is guaranteed by a clearing member. This can be the case in some circumstances, but there may be circumstances where this assumption would not hold.

The ultimate objective of having capital treatment for different types of assets based on their riskiness is to ensure solvency of a financial institution and its ability to withstand the shock in a stress environment. Consequently, the focus of risk weight calibration should be on the ultimate outcome for a bank, a counterparty, and a financial system in the event of a CCP default. To evaluate the ultimate outcome of a CCP failure, it is necessary to understand the loss-sharing agreement of a particular CCP. "Different loss-sharing arrangements result in different allocation of losses. For example, unlimited assessment calls expose clearing members and shareholders to theoretically unlimited liabilities. Liquidation and tearing-up of trades will create externalities to counterparties of the defaulter. Variation Margin Gains Haircutting (VMGH) place the burden on those clearing members or clients that made financial gains on their position as the CCP keeps those to cover the losses on the position of the defaulter."[12] Consequently, it is important to evaluate the impact of a CCP default on a clearing member bank. To do so, it is necessary to understand how a CCP loss-sharing would look like and what would be the potential recovery and resolution for a CCP.

[12] Froukelien Wend, *Central Counterparties: Addressing their Too Important to Fail Nature*, IMF Working Paper (Jan. 27, 2015) at 7.

The diagram presented in the IMF Global Financial Stability Report of April 2010 provides typical CCP lines of defense against clearing member default:[13]



Source: IMF staff.
Note: This is an illustrative example of lines of defense of a CCP. It should be noted that these structures, orders, and nomenclature vary in each CCP and there is not a legally mandated one (although their differences clearly have significant financial and operational implications). This figure assumes that a clearing member defaults because a customer fails to meet its obligations and its collateral is insufficient. Clearing member defaults may be triggered for other reasons, even ones unrelated to the derivative product involved in the transaction.
[1]The first-loss pool is an initial level of funds contributed by the CCP, which even if absorbed would still allow the CCP to continue to function.

The noteworthy element in this simplified diagram is that CCP claims or capital calls and clearing member contributions take place irrespective of whether or not the exposure was guaranteed by a clearing member. In other words, if any participant of a CCP defaults, ultimately clearing members and/or CCP shareholders do face an unlimited liability. To

13 IMF Global Financial Stability Report (Apr. 2010), at 17.

address this vulnerability, regulators impose strict risk management requirements to ensure the solvency and liquidity of a CCP. Yet, as the diagram above shows, another essential element of CCP risk management is to ensure that clearing members themselves have adequate capital and liquidity to withstand CCP shocks. That brings into focus how cleared transactions exposure should be treated by a clearing member from the standpoint of its capital adequacy, if such a transaction fails as a result of a client failure or a CCP failure. In case of an idiosyncratic client failure and subject to segregation of collateral on a CCP level, the impact for a clearing member most likely will be minimal. However, in case of a CCP failure or a multiple client failures at the same time, it is not clear whether a clearing member will be exposed to capital calls and contribution requirements from a CCP. While clearing members themselves may argue against the unlimited guarantees that clearing members provide to a CCP and argue for "pre-defined, limited, reasonable and quantifiable"[14] calls, it is clear that a clearing member must have capital buffers in place to support CCP capital calls and contribution demands, either when it directly guarantees client exposure or when it is indirectly subject to general CCP's claims or capital calls.

The Basel Committee on Banking Supervision ("BCBS") report on "Capital requirements for bank exposures to central counterparties"[15] recognizes this challenge when it states "where the bank is acting as a clearing member, the bank should assess through appropriate scenario analysis and stress testing whether the level of capital held against exposures to a CCP adequately addresses the inherent risks of those transactions. This assessment will include potential future or contingent exposures resulting from future drawings on default fund commitments, and/or from secondary commitments to take over or replace offsetting transactions from clients of another clearing member in case of this clearing member defaulting or becoming insolvent."[16]

Taking the above BCBS concern into consideration, it is prudent and conservative for financial regulators to require clearing members to main sufficient levels of capital to mitigate the propagation of a contagion risk stemming from the failure of a CCP or the failure of multiple participants of a CCP. A minimum two percent risk weight to trade exposure for any cleared transaction, irrespective of a guarantee status, should be a universal, automatic minimum level of defense to stabilize a CCP via clearing members' capital contributions.

The importance of requiring clearing members to meet capital requirements sufficient to withstand a CCP shock is accentuated by the fact that there is no clear understanding or process for a CCP recovery and resolution. That potentially may mean that the FDIC and/or the Board may be involved or even responsible for CCP recovery and resolution actions. This suggests that based on the current waterfall of liabilities in case of a CCP default, it is the responsibility of prudential regulators to ensure the adequate capital

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14 ISDA, *CCP Default Management, Recovery and Continuity: A Proposed Recovery Framework* (Jan. 2015), at 4.

15 Basel Committee on Banking Supervision, *Capital requirements for bank exposures to central counterparties* (Apr. 2014).

16 *Id.*, at 4.

position of clearing members with respect to their CCP exposure to minimize the probability of taxpayer bail-outs of CCPs as a result of clearing members' inability to meet CCP's claims and capital calls. Consequently, a universal two percent risk weight for trade exposure for cleared transactions should be a first level, minimum requirement for clearing members.

In addition, this risk weight should be supplemented by a second layer of minimum capital requirements to satisfy not only default fund exposure but also contribution to a CCP guarantee fund as well as further CCP claims and capital calls. Clearing members provide unlimited guarantees to a CCP and, as a result, there should be a correlation between the aggregate CCP exposure and the capital capacity of each CCP clearing member to cover that exposure. Because a two percent risk weight to trade exposure for cleared transactions is not by itself sufficient to ensure the resilience of clearing members and CCPs, the capital requirements should be strengthened rather than weakened to ensure that prudential regulators can deal with the failure of clearing members and CCPs in an orderly manner, without recourse to a taxpayer bailout of those institutions.

The twenty business day margin-period-of-risk requirement should be a universal minimum requirement for all cleared transactions.

The reason for preserving the twenty business day margin-period-of-risk requirement is fundamentally similar to the reason for preserving the two percent risk weight to the trade exposure amount for a cleared transaction. The Proposed Rule would exempt "netting sets subject to a collateral agreement that exceeds 5,000 trades at any time during the previous quarter from the twenty business day margin-period-risk requirement unless the netting set contains illiquid collateral, OTC derivatives that cannot easily be replaced, or the banking organization had two or more margin disputes with the counterparty over the previous two quarters that last for a certain length of time."[17] This, however, is based on flawed assumptions about the liquidity of those positions.

The Proposed Rule is explicit about the liquidity assumption: "the agencies believe that unlike a large netting set of over-the-counter derivatives, a large netting set of cleared transactions would not require a lengthy period to close out in the event of a default of the CCP."[18] There is no empirical evidence provided as to why a large size trade of any instrument would not attract a liquidity premium comparable to that of small size trades irrespective of whether the trade takes place in an exchange-like environment or in the OTC market. The Commodity Futures Trading Commission historically allowed execution of block trades (large size trades) off exchanges because of their impact on market price and liquidity premiums. Furthermore, there is not only lack of historical records to confirm the preservation of large cleared netting set liquidly when a CCP defaults, there is no evidence to confirm the preservation of contract liquidity during a CCP non-default.

17 Proposed Rule, at 18.
18 *Id*.

History demonstrates that markets (and regulators) frequently underestimate or misunderstand the liquidity risk and liquidity premiums of assets. The IMF December 2014 paper, "A Simple Macroprudential Liquidity Buffer," noted that:

> "[T]he liquidity properties of assets and liabilities can change abruptly during crisis periods; information amplifiers may render illiquid assets that are normally to be close substitute for cash, or subject even notionally long-term liabilities to 'runs.'"[19]

As Associate Professor at University of Notre Dame, Colleen Baker, addresses the same question from a liquidity pricing angle:

> "Liquidity is not free. Liquidity risk is one of the fundamental risks in financial markets. All else being equal, liquid financial assets are less risky than illiquid onces and, therefore, worth more. Financial investors generally expect to receive a "liquidity premium" for illiquid financial assets. In the past, however, both economic and financial theories have sometimes treated liquidity as costless. And **international financial institutions have long mismanaged and mispriced liquidity risk**."[20]

In light of the historical mis-pricing of the liquidity premiums, and the absence of empirical evidence to validate the assumption that large netting sets of over-the-counter derivatives do not require a lengthy period to close out in the event of a default of the CCP, the agency should follow a conservative, prudent approach in the calibration of risk adjustments. The universal model of the twenty-business day margin-period-of-risk requirement already adopted by agencies should be the base-line requirement, and it should not be decreased for any categories of transactions unless there is empirical evidence available to confirm that those instruments indeed have lower liquidity premiums. Historical under-calculation of a liquidity premium accompanied by no clear model of a CCP recovery and resolution raises concerns about the ability to unwind large netting sets during the period of a CCP default.

Moreover, as Lehman Brothers' failure demonstrated, an instrument that appears to be liquid today may be absolutely non-liquid during a stress period. Consequently, unless there is empirical evidence to substantiate the assumption of low liquidity premiums for large netting sets, the agencies should assume that increasing liquidity premiums are appropriate for those positions during the period of stress (such as a CCP default). In short, they should adhere to their own stated policy, which provides that "for any netting set that involves illiquid collateral or OTC derivatives that cannot easily be replace, or that has two margin disputes within a netting set over the previous two quarters that last for a certain length of time, the margin period of risk would require adjustments, . . . regardless of whether the netting set consists of cleared transactions."

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19 Daniel C. Hardy and Philipp Hochreiter, *A Simple Macroprudential Liquidity Buffer*, IMF Working Paper (Dec. 2014), at 5.

20 Colleen Baker, *The Federal Reserve as Last Resort*, 46 U. MICH. J. L. REFORM 69, 78 (2012) (emphasis added).

CONCLUSION

This comment letter encourages agencies to undertake an empirical analysis of the recovery and resolution regime for CCPs and its impact on the clearing members' exposure to CCPs for cleared transactions, prior to creating an exemption from the two percent risk-weight-to-trade exposure.

The comment letter also suggests that agencies need to conduct a study of liquidity premiums for large netting sets during normal and stress times to determine their eligibility for an exemption from the twenty business day margin-period-of-risk requirement. Available observations suggest that the larger the position being traded, the longer and more expensive it is to liquidate it. The Proposed Rule assumes the opposite while not providing the empirical evidence to substantiate this assumption. Absent credible empirical evidence, the agencies should not reduce the established capital requirements outlined above.

We hope these comments are helpful as the Agencies strengthen the Proposed Rule, so that the final rule provides for a sound regulatory capital framework.

Sincerely,

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