

August 8, 2019

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Attention: Comments/RIN 3064-AE80
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Via: regs.comments@federalreserve.gov

Re: Standardized Approach for Counterparty Credit Risk (“SA-CCR”) - Addendum

Board: Docket No. R-1629
FDIC: RIN 3064-AE80,
OCC: Docket ID OCC-2018-003

Dear Sir/Madam,

We write to you to follow up on concerns raised in the March 18, 2019 comment letter submitted by the American Bankers Association (“ABA”), the Bank Policy Institute (“BPI”), the Futures Industry Association (“FIA”), the International Swaps and Derivatives Association, Inc. (“ISDA”), and the Securities Industry and Financial Markets Association (“SIFMA”), (together, the “Associations” and the “Associations’ Letter”) on the above-referenced proposal (the “Proposed Rulemaking”) from the Board of Governors of the Federal Reserve System (“FRB”), the Federal Deposit Insurance Corporation (“FDIC”), and the Office of the Comptroller of the Currency (“OCC”) (together, the “Agencies”).¹

The two concerns for which we would like to provide additional information include:

¹ Standardized Approach for Calculating the Exposure Amount of Derivative Contracts; Notice of Proposed Rulemaking, 83 Fed. Reg. 64,660 (Dec. 17, 2018), available at <https://www.govinfo.gov/content/pkg/FR-2018-12-17/pdf/2018-24924.pdf>.

- Netting of CTM and STM trades (Answers to Questions Asked)
- Data from qualifying central counterparties (“QCCPs”) required for SA-CCR implementation

On June 11, FIA had a meeting with staff from the FRB, FDIC and OCC to discuss a few issues highlighted in the Associations Letter. During that time, three questions were raised by the FRB relating to settled-to-market transactions (“STM”) and collateralized-to-market (“CTM”) transactions and their ability to net. The three questions asked are reiterated below with the Associations’ responses to those questions.

We also are highlighting a concern from the Appendix 2.4 of the Associations’ Letter, regarding data required for implementing SA-CCR that may be difficult to obtain. Under the Proposed Rulemaking, required default fund contribution exposures present potential problems for banks to implement SA-CCR due to their need to rely on QCCPs for data required by the methodology. Further, banks may face material, punitive increases to the RWA for both their default fund contribution exposures and their cleared transaction exposures due to the inability of QCCPs to provide the required data.

I. Netting of CTM and STM trades (Answers to Questions Asked)

Questions asked by Federal Reserve

- 1. How common is it that STM and CTM trades would be the subject of the same netting agreement with a client, and how would this arise?**

Answer:

Clearing of STM transactions and CTM transactions subject to the same Qualifying Master Netting Agreement (“QMNA”) will be prevalent across exchange traded derivatives, options and OTC cleared swaps as set out further below.

Exchange-traded derivatives (“ETDs”)

- ***US and non-US members of CCPs that clear options on futures with equity-style margining – house and client positions.*** Positions, whether house or client, in options on futures with equity-style margining (“ESO”), which are CTM transactions, are ***invariably*** included in the same netting sets with futures and options on futures with futures-style margining (“FSO”), both of which are STM products, and this has been the case for decades.² In the US, this practice is a regulatory requirement in the case of client positions, as the CFTC requires that futures and FSO (STM) and ESO contracts (CTM)

² Equity-style margining has been referred to as the “traditional” margining style for options on futures as FSO are the more recently developed product.

be cleared through the same account, effectively requiring they be subject to a single QMNA.

- CCPs that clear options on securities and futures together as part of a cross-margining program.** In addition, options on securities are always ESO (i.e., CTM) transactions and may be included in the same netting sets with futures and FSO (i.e., STM trades) when there is a cross-margining arrangement with respect to these products. For example, customers that are broker-dealer market makers participate in futures (STM) and options on securities (CTM) cross-margin programs, such as the one offered by the CME and OCC. This type of program, which has received regulatory approval from the SEC and CFTC, permits such customers to have their options on securities held in their CFTC-regulated futures account along with their futures. All such positions held in the futures account would be subject to a single QMNA (i.e., the FCM’s futures account agreement). In addition, many institutions offer prime brokerage arrangements where futures and ESOs [as well as uncleared swaps] are margined under a prime brokerage arrangement. A typical prime brokerage agreement contains default set-off provisions which, in respect of exposures between a single entity and a single customer, would meet the definition of a QMNA.
- ETD STM and CTM contract examples by CCP:**

CCP	STM	CTM
ICE	Brent Crude Gas Oil Penultimate Henry Hub	ICE-ECX Carbon Financial Instrument WTI Crude Penultimate Henry Hub (Equity)
CME	All futures contracts -- examples: <ul style="list-style-type: none"> ▪ Eurodollar futures ▪ 10-year T-note futures <ul style="list-style-type: none"> ▪ Corn futures ▪ Gold futures 	ESO on futures – examples: <ul style="list-style-type: none"> ▪ Eurodollar options ▪ 10-year T-note options <ul style="list-style-type: none"> ▪ Corn options ▪ Gold options

The market practice is to net all trades under the cross-margining program. Under the Proposed Rulemaking, netting would not be allowed because the futures product is STM and the options product is CTM.

OTC Cleared Swaps

- **Non-US members of non-US CCPs:** Some non-US CCPs (LCH Limited, Eurex, JSCC and LCH SA) have amended or are in the process of amending their rules to permit their non-US clearing members the option to elect to clear house and/or client positions that are STM, CTM or both STM and CTM, while other non-US CCPs have proposed rule amendments that would mandate their members may only clear house and client positions that are STM (ICE Clear Europe and ASX Clear (Futures)).
 - **Client positions.** In the case of the few CCPs that permits optionality, a clearing member cannot not elect STM treatment for a client’s swaps without the client’s consent. If the clearing member has a client that does not consent to clear only STM contracts through such a CCP and the member also clears for the client through a different CCP that permits only STM contracts, the client could end up with a mixed CTM/STM netting set under its clearing agreement with the member (as the client agreement covers transactions cleared on multiple CCPs). Further clearing members clear OTC swaps and ETDs under a single QMNA and given most OTC swaps in Europe are still treated on a CTM basis they are currently under the same netting set with ETDs (which are STM).
- **Cleared swap STM and CTM contracts by CCP:**

CCP	Service/Product	STM	CTM
ICE Clear Credit (US)	CDS	All contracts—mandatory	Not permitted
CME (US)	IRS	All contracts—mandatory	Not permitted
LCH Limited (UK)	SwapClear FCM IRS	All contracts – mandatory	Not permitted
	ForexClear FCM FX	All contracts—mandatory	Not permitted
	SwapClear SCM IRS	CCP provides optionality to its clearing members to make STM or CTM election for house and client accounts	

	ForexClear FX	CCP provides optionality to its clearing members to make STM or CTM election for house and client accounts	
Eurex (Germany)	IRS/FX/XCCY	CCP provides optionality to its clearing members to make STM or CTM election for house and client accounts	
	FCM IRS	All contracts— mandatory	Not permitted
JSCC (Japan)	IRS	CCP provides optionality to its clearing members to make STM or CTM election for house and client accounts	
LCH SA (France)	CDS FCM	All contracts— mandatory	Not permitted
ICE Clear Europe (UK) ³	CDS	All contracts— mandatory	Not permitted
ASX Clear (Futures) (AU) ⁴	IRS	All contracts— mandatory	Not permitted

Apart from the clearing related examples mentioned above, STM and CTM trades could also exist in the same netting set is when banks utilize LCH SwapAgent for some of their bilateral transactions. Regarding trades processed through LCH SwapAgent, banks can elect either STM or CTM. Trades that do not go through LCH SwapAgent are subject to a bilateral Credit Support Annex (CSA)³ and therefore would necessarily be classified as CTM. Trades channeled through

³ Proposed amendments to the CCP's rules to convert all contracts from CTM to STM are expected to become effective in 2019.

⁴ Proposed amendments to the CCP's rules to convert all contracts from CTM to STM are expected to become effective on October 28, 2019.

LCH SwapAgent would continue to be subject to the same ISDA Master agreement as those subject to a bilateral CSA and therefore would be part of the same netting set.⁵

2. Is the mixing of STM and CTM trades within a single netting agreement a transitional issue (e.g., if the market will eventually move entirely to STM) or will it be an ongoing issue?

Answer:

ETD

- **NOT transitional.** It will be an on-going issue. As explained above, the futures-style and equity-style margining processes that exist for futures and options on futures, as well as for regulatory-approved cross-margin programs for options on securities and futures, have been in place for a very long period of time as a standard market practice across CCPs and even within individual CCPs at the product level. Further, these are both acceptable margining practices under CFTC rules and regulations. There is no compelling economic rationale to expect the markets to move towards STM for all CTM trades as these are mature products and the risk economics are identical irrespective of which margin process is applied. Changing the framework would be a non-trivial change for the derivatives market and would likely require supervisory review from the CFTC and/or SEC, as applicable.

OTC Cleared Swaps

- **Non-US members of non-US CCPs - Client positions.** Not transitional and not manageable as election of whether OTC contracts are treated as STM or CTM are dependent on the CCP as well as Client election.

3. How would netting of STM and CTM trades under a single QMNA actually get enforced in the event of the counterparty's bankruptcy?

Answer:

ETD and cleared swaps

⁵ For more information, please see the FIA, ISDA, ABA, SIFMA, BPI Comment letter; <https://fia.org/articles/fia-isda-aba-sifma-and-bpi-call-fed-review-capital-rules>.

- **House and client positions – CCP insolvency:** In the event of a CCP’s insolvency, closeout netting of the ETD and cleared swap positions carried in a clearing member’s house account(s) would be conducted in accordance with the CCP’s rules or bylaws (or some other written agreement between the CCP and the clearing member), which would constitute the QMNA between the CCP and the clearing member.
 - The terms of such rules, bylaws or other written agreements vary by CCP, but as a general matter, they provide that all the clearing member’s open positions would be closed out and closeout values would be assigned to the positions. Such closeout values (which could be due to the CCP and/or clearing member) would be netted with the value of any collateral (or collateral liquidation proceeds), which would be due to the party that provided the collateral, to arrive at a single, net closeout amount due to the CCP or the clearing member. Such closeout netting would occur with respect to all ETD and cleared swaps positions of the clearing member, regardless of their characterization as STM or CTM contracts.
 - A separate net closeout amount would be calculated for (i) each of the client accounts maintained by the clearing member with the CCP and (ii) all of the clearing member’s house accounts (on a combined basis) maintained by with the CCP. As a result of the CFTC’s client account rules, client ESO positions would be carried in the same accounts as futures and FSO positions and would be netted together.

- **Client positions in OTC Cleared Swaps and ETD – client insolvency:** It is market practice for clients to maintain both ETD positions and OTC swaps cleared through multiple CCPs with a single clearing broker, under a single QMNA, regardless of whether they are STM or CTM. Indeed, as noted above, under CFTC rules in the US, client ESO contracts and futures and FSO contracts⁶ are required to be carried in the same account. In the event of an insolvency of a client, closeout netting of the ETD and cleared swap positions carried for the client by a clearing broker would be conducted in accordance with a written agreement⁷

⁶ As well as options on securities in a regulatory-approved cross-margining program

⁷ As a general matter, such agreement consists of:

- for a client that clears only ETD, an account agreement
- for a client of a US FCM that clears both ETD and swaps or only swaps, an account agreement and an OTC addendum (which together constitute a single agreement)
- for a client of a non-FCM clearing broker that clears both ETD and swaps, an account agreement and an OTC addendum (which together constitute a single agreement)
- for a client of a non-FCM clearing broker that clears only swaps, either an account agreement and an OTC addendum or an ISDA Master Agreement and an OTC addendum (which together constitute a single agreement)

between the client and clearing broker pursuant to which the clearing broker provides clearing services to the client.

- Such agreement constitutes a QMNA, providing the clearing broker, upon the client's insolvency, liquidation, netting and set-off rights with respect to the client's positions and collateral. As a general matter, the clearing broker would exercise such rights to determine a single balance due to or from the client in respect of the account in which positions of a particular product are carried and, if the client clears more than one product, to net the balances of the different product accounts down to a single balance due to or from the client.

II. Data from QCCPs required for SA-CCR implementation

As noted in the Associations' Letter⁸, changes to the methodology for banks that are clearing members of QCCPs to calculate the risk weighted assets ("RWA") for their default fund contribution exposures present potential problems for banks to implement SA-CCR due to their need to rely on QCCPs for data required by the methodology. Further, banks may face material, punitive increases to the RWA for both their default fund contribution exposures and their cleared transaction exposures due to the inability of QCCPs to provide the required data.

The Proposed Rulemaking would eliminate Method One and Method Two in the current U.S. regulatory capital rules⁹ and provide a new method for a clearing member to determine the RWA amount for its default fund contributions to QCCPs.¹⁰ In order to perform the new calculation, banks are required to independently calculate the hypothetical capital requirement (using data provided by the QCCP) or they may rely on a value provided by the QCCP. However, when a QCCP does not provide its hypothetical capital requirement (or, alternatively, the required data), banks would be required to apply the more punitive methodology for default fund contributions to non-qualifying central counter parties ("CCPs"), which applies a 1250% risk weight.¹¹

Both domestic and foreign QCCPs may not be prepared to provide the data required by banks to perform the calculations in the new methodology. No current or proposed domestic regulation directly requires U.S. QCCPs to provide this data. In addition, QCCPs outside of the United States may not be operationally prepared to provide the requisite data for two reasons. First, the Proposed Rulemaking requires the hypothetical capital requirements of a QCCP to be calculated based on the US rule, in particular Section 132(c). However, a foreign QCCP would generally

⁸ See Response to Question 14, page 47, and Appendix 2.4, pages 61-62, of the Associations' Letter.

⁹ Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,081, 62,226 (Oct. 11, 2013), available at <https://www.govinfo.gov/content/pkg/FR-2013-10-11/pdf/2013-21653.pdf>.

¹⁰ See § 133(d)(4) of the Proposed Rulemaking.

¹¹ See § 133(d)(2) of the Proposed Rulemaking.

calculate the hypothetical capital requirements based on Basel Committee standards or the standard of relevant foreign jurisdiction in which QCCP is based. At this point, the industry does not expect that foreign QCCPs would perform a separate calculation based on U.S. SA-CCR rules in addition to the calculation required for foreign banks in their own jurisdiction. Second, it is not clear at the present time that foreign QCCPs are prepared, or planning to, perform these additional SA-CCR based calculations or to make the necessary disclosures. This is particularly the case given that SA-CCR implementation timelines in other jurisdictions might not align with that of the US. For example, SA-CCR in the EU will only become effective in June 2021.

Furthermore, a QCCP that fails to provide such data would also fail to satisfy the operational requirements in the U.S. regulatory capital rules for qualifying as a QCCP. Under the U.S. regulatory capital rules, a QCCP must provide banks with its hypothetical capital requirement or the information necessary to calculate such hypothetical capital requirement.¹² When clearing transactions through a QCCP, Banks may use the QCCP risk weight (either 2% or 4%) to calculate the RWA of their cleared transaction exposures to the QCCP.¹³ However, banks must calculate RWA for their cleared transaction exposures at non-qualifying CCPs by reference to the risk weight for corporate counterparties under the Standardized Approach, which is 100%.¹⁴ Therefore, the inability of a QCCP to provide the required data to banks may result in RWA for cleared transaction exposures at formerly qualifying QCCPs increasing substantially (e.g., 2% to 100%). In addition, a bank would also not be allowed to assign a lower margin period of risk (MPOR) of five business days instead of ten business days to client cleared exposures cleared through a non-QCCP.

In order to further inform our comments regarding the anticipated impact of the new default fund contribution exposure methodology, the Associations have conducted a data survey among seven (7) financial institutions.¹⁵ These institutions account for 89.51% of total derivatives notional outstanding at the top 25 bank holding companies.¹⁶ The data collected represents data from four or more of the seven banks in the data study. The data survey requested information on the institutions' default fund contribution and cleared transaction exposures at U.S. and foreign QCCPs. The tables below present this data and the projected impacts of QCCPs being unable to provide the data necessary under the Proposed Rulemaking. **Figure 1** presents the increase in RWA for default fund contribution exposures at U.S. QCCPs, assuming that no current QCCP provides the required data by the implementation date. **Figure 2** presents the increase in RWA

¹² See § .3(f) and § .2, definition of 'qualifying central counterparty (QCCP)', 2(i), of the current U.S. regulatory capital rules

¹³ See § .35(b)(3)(A)-(B) and § .133(b)(3)(A)-(B) of the current U.S. regulatory capital rules.

¹⁴ See § .35(b)(3)(A)-(B) and § .133(b)(3)(A)-(B), and § .32 of the current U.S. regulatory capital rules.

¹⁵ In the short amount of time, banks were not able to calculate the impact of assigning a higher MPOR to client cleared exposures as a result of a QCCP becoming a CCP.

¹⁶ Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities (Feb. 2018), available at <https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr3-2018.pdf>

for default fund contribution exposures at Non-U.S. QCCPs, assuming that no current QCCP provides the required data by the implementation date. **Figure 3** presents the increase for cleared transaction exposure RWAs at U.S. QCCPs if current QCCPs fail to qualify due to failure to provide the required data by the implementation date and are treated as non-qualifying CCPs. **Figure 4** presents the increase for cleared transaction exposure RWAs at non-U.S. QCCPs if current QCCPs fail to qualify due to failure to provide the required data by the implementation date and are treated as non-qualifying CCPs.

Figure 1: U.S. QCCPs’ Default Fund Contribution RWA Increase (\$mm as of 4Q2018)

U.S. QCCPs				
Current			SA-CCR	
Default Fund Amount	Advanced RWA	Standardized RWA	1,250% RW*	Δ Standardized RWA
16,844	5,385	5,930	210,550	204,620
*This represents value for the Standardized Approach; the Advanced Approaches Calculation would be 6% greater.				

Figure 2: Non-U.S. QCCPs’ Default Fund Contribution RWA Increase (\$mm as of 4Q2018)

Non-U.S. QCCPs				
Current			SA-CCR	
Default Fund Amount	Advanced RWA	Standardized RWA	1,250% RW*	Δ Standardized RWA
14,218	6,377	7,403	177,725	170,322
*This represents value for the Standardized Approach; the Advanced Approaches Calculation would be 6% greater.				

Figure 3: Cleared Transaction Exposure RWA Increase for U.S. QCCPs (\$mm as of 4Q2018)

U.S. QCCPs							
Current				SA-CCR			
Advanced Trade Exposure	Standardized Trade Exposure	Trade Exposure Advanced RWA	Trade Exposure Standardized RWA	CCP Trade Exposure Advanced RWA	Δ Advanced RWA	CCP Exposure Standardized RWA	Δ Standardized RWA
89,237	135,729	1,795	2,548	94,591	92,796	135,729	133,181

Figure 4: Cleared Transaction Exposure RWA Increase for Non-U.S. QCCPs (\$mm as of 4Q2018)

Non-U.S. QCCPs							
Current				SA-CCR			
Advanced Trade Exposure	Standardized Trade Exposure	Trade Exposure Advanced RWA	Trade Exposure Standardized RWA	CCP Trade Exposure Advanced RWA	Δ Advanced RWA	CCP Exposure Standardized RWA	Δ Standardized RWA
208,776	314,848	4,097	6,097	221,302	217,205	314,848	308,751

Under a ‘worst case scenario’, the relatively small current RWA for default fund contribution and cleared transaction exposures to QCCPs becomes a meaningful driver of increases to bank regulatory capital. Even assuming that some QCCPs are capable of performing U.S. SA-CCR compliant calculations or providing similar data by the time banks implement it, there is a significant risk that RWA for these exposures will increase punitively due to exposures at some QCCPs that must be treated as exposures to non-qualifying CCPs, especially in the case of foreign QCCPs. This increase would occur despite that fact that the risk profile, risk management practices, legal regimes, and other substantive requirements related to being a QCCP have not changed. This increase would also run counter to the Pittsburgh G20 Leaders’ commitment to derivatives clearing and US policies designed to promote central clearing of derivatives in order to increase financial stability, including by implementing lower capital requirements for cleared derivatives.

In light of the foregoing, we would make several recommendations to the Agencies:

- **Substituted Compliance:** The Agencies should explicitly allow U.S. banks to rely on the value of a QCCP’s hypothetical capital requirement based on the local or Basel Committee SA-CCR standards.

- **Transitional Arrangements:** The Agencies should allow banks to continue using the current Method 2 for the calculation of their default fund contribution exposures and for QCCPs to continue to qualify using current methodologies to calculate hypothetical capital requirements for a transitional period.
- **Regulatory Coordination:** The FRB should revise Regulation HH to require that QCCPs regulated by the FRB provide any information required to calculate the QCCP's hypothetical capital requirement for their clearing members' RWA calculations. In addition, the Agencies should work with the SEC and CFTC and with IOSCO and foreign regulators to ensure that the necessary data is available to U.S. banking organizations in time for U.S. implementation of SA-CCR or as soon as practicable thereafter, assuming there is substituted compliance or a transitional arrangement.

Due to the material potential impacts, we recommend that the Agencies address these recommendations directly through clarifications to the rule text when the final rulemaking is adopted. While we believe that rule text clarification would be most appropriate, the Agencies might alternatively address these recommendations through guidance in the final rule preamble.