



U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581

February 15, 2019

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
Department of Treasury
400 7th Street, SW
Suite 3E-218
Washington, DC 20219
regs.comments@occ.treas.gov

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Comments@FDIC.gov

RE: Capital Adequacy: Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, OCC Docket ID OCC-2018-0030 and RIN 1557-AE44; Board Docket No. R-1629 and RIN 7100-AF22; FDIC RIN 3064-AE80

Dear Legislative and Regulatory Activities Division, Secretary Misback, and Executive Secretary Feldman:

We are writing to comment on the notice of proposed rulemaking issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the

Federal Deposit Insurance Corporation (together; the agencies) to implement a new approach for calculating the exposure amount of derivatives contracts under the agencies' regulatory capital rules (Proposal)^{1,2} As set forth below, the Proposal has significant ramifications on the markets that we oversee.

Question 17: The agencies invite comment on the recognition of collateral provided by clearing member client banking organizations in connection with a cleared transaction for purposes of the standardized approach for counterparty credit risk (SA-CCR) methodology. What are the pros and cons of recognizing such collateral in the calculation of replacement cost and potential future exposure? Commenters should provide data regarding how alternative approaches regarding the treatment of collateral would affect the cost of clearing services, as well as provide data regarding how such approaches would affect leverage capital allocation for that activity.³

The Failure to Acknowledge the Risk-Reducing Impact of Client Initial Margin in the Calculation of the Supplementary Leverage Ratio Has Reduced the Availability of Clearing Services in Contravention of G20 Mandates.

Capital standards and clearing of standardized derivatives are two fundamental components of financial regulatory reform under the Dodd-Frank Act.⁴ When implemented appropriately, bank capital standards for uncleared and cleared swaps should not discourage central clearing. However, market data, academic research, and feedback from a diverse landscape of financial and end user firms indicate that one of the implemented capital standards – namely, supplementary leverage ratios (SLR) – is working counterproductively, limiting access to derivatives risk management strategies and discouraging the central clearing of standardized swap products.

¹ Standardized Approach for Calculating the Exposure Amount of Derivative Contracts, 83 Fed. Reg. 64,660 (proposed Dec. 17, 2018) (hereinafter, the "Proposal"), available at <https://www.federalregister.gov/documents/2018/12/17/2018-24924/standardized-approach-for-calculating-the-exposure-amount-of-derivative-contracts>.

² The views expressed herein are those of Chairman J. Christopher Giancarlo, Commissioner Brian D. Quintenz, Commissioner Rostin Behnam and Commissioner Dan M. Berkovitz, and not necessarily those of the Commodity Futures Trading Commission (CFTC) or its staff. Commissioner Dawn DeBerry Stump has recused herself from commenting on the Proposal.

³ Proposal at 64,683.

⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010), available at <https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.

The Proposal requires clearing member client banking organizations (clearing members) to use a modified version of SA-CCR to determine the on- and off-balance sheet amounts of derivative contracts for the purposes of calculating total leverage exposure.⁵ As with the current exposure method (CEM), the SA-CCR calculation does not include an offset for segregated initial margin that the clearing members hold on behalf of clients.⁶ The adoption of SA-CCR without offset will maintain or increase the clearing members' SLRs by more than 30 basis points on average⁷, will continue to disincentivize clearing members from providing clearing services, and thereby limit access to clearing in contravention of G20 mandates⁸ and Dodd-Frank.

CEM and SA-CCR require a clearing member to include in its SLR calculation the full exposure resulting from its guarantee of a client's trade, without reducing this exposure by the amount of segregated initial margin posted by the client. Moreover, they count the segregated margin as a source of leverage against which the clearing member must hold additional capital. This ignores the strict limitations on the clearing member's access to those segregated client funds.

Under CFTC regulations, when margin is segregated, it remains the property of the client.⁹ A clearing member may only use client funds to meet that client's obligations. In the event of a client default, the clearing member may use the client's margin to cover losses resulting from the client's positions.¹⁰ The clearing member cannot use segregated client margin

⁵ Proposal at 64,683.

⁶ *Id.*

⁷ *Id.* at 64,685.

⁸ *G20 Leaders' Statement, Framework for Strong, Sustainable and Balanced Growth, The Pittsburgh Summit* (Sep. 24-25, 2009), https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

⁹ See Section 4d of the Commodity Exchange Act, 7 U.S.C. § 6d (2012).

¹⁰ See CFTC Regulations 1.20-1.30, 17 C.F.R. §§ 1.20-1.30 (2018) (futures) and CFTC Regulations 22.2-22.7, 17 C.F.R. §§ 22.2-22.7 (2018) (cleared swaps). These rules require futures commission merchants (FCM) to separately

to leverage itself under any circumstance.¹¹ Segregated margin is, by definition, risk-reducing. Failing to reduce a clearing member's exposure by the segregated client margin it holds results in an inflated measure of the clearing member's exposure for a cleared trade.

Imposing a SLR without offset has a significant impact on clearing members. The Derivatives Assessment Team (DAT), formed by the Financial Stability Board, the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, and the International Organization of Securities Commissions, recently concluded that "the treatment of initial margin in the leverage ratio can be a disincentive for client clearing service providers to offer or expand client clearing" and "this might translate into higher costs for clients and a reduced availability of clearing services."¹² According to the DAT Report, 89% of client clearing service providers found the SLR to have a negative or significant negative impact on their ability to offer client clearing services, with two-thirds saying it has a significant negative impact.¹³ The DAT's concerns are supported by CFTC research indicating that differing implementations of leverage ratios may have driven market share from United States firms with high leverage requirements to European Union firms with lower requirements.¹⁴ The Bank of

account for, and segregate as belonging to the client, all money, securities, and property received from a client as margin. The FCM cannot re-hypothecate the margin to leverage the bank and must maintain the collateral in cash or certain other very low risk, highly liquid assets, such as U.S. government and municipal securities "with the objectives of preserving principal and maintaining liquidity." 17 C.F.R. § 1.25 (2018)

¹¹ *Id.*

¹² Derivatives Assessment Team, *Incentives to Centrally Clear Over-the-Counter (OTC) Derivatives: A Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms – Final Report*, at 4, 67 (Nov. 19, 2018) (hereinafter, the "DAT Report"), available at <http://www.fsb.org/2018/11/incentives-to-centrally-clear-over-the-couunter-otc-derivatives-2/>.

¹³ *Id.* at 65.

¹⁴ CFTC Policy Brief, *Assessing the Impact of the Basel III Leverage Ratio on the Competitive Landscape of US Derivatives Markets: Evidence from Options* (June 15, 2018), www.cftc.gov/sites/default/files/About/Economic%20Analysis/oce_leverage_and_options.pdf.

England also found that the leverage ratio has disincentivized banks from engaging in client clearing in the United Kingdom.¹⁵

Unless the treatment of client margin changes under SA-CCR, clearing members will continue to limit the provision of clearing services or exit the clearing business and the worrisome trend of clearing member consolidation will continue. CFTC data reveals that the number of firms providing clearing services in the U.S. has dropped from 84 in 2008 to 55 in 2018.¹⁶ The DAT Report states that the top five clearing members in the U.S., U.K. and Japan handle 80% of the cleared client trading activity for interest rate swaps in those jurisdictions.¹⁷ SA-CCR's failure to offset for margin may further exacerbate the concentration of clearing members and thereby reduce access to clearing. Further contraction of clearing members could increase systemic risk, and the associated reduction in the provision of clearing services is inconsistent with the fundamental reforms in Dodd-Frank.

The DAT Report also found that clearing member consolidation driven by the SLR may limit the number of clearing members available to take on the book of a defaulting clearing member.¹⁸ Finding a clearing firm willing to port in trades during times of stress (with increased margin levels) may be exceptionally difficult, especially for firms already struggling with their SLRs.¹⁹ This may exacerbate systemic risks in the event of a failure by a clearing member.

We believe an SLR calculation that allows initial margin to offset potential future exposures would remove an unnecessary obstacle to banks offering client clearing services, consistent with G20 mandates and Dodd-Frank. An increased number of clearing members

¹⁵ Bank of England, *The Impact of the Leverage Ratio on Client Clearing*, Staff Working Paper No. 735 (June 15, 2018), <https://www.bankofengland.co.uk/working-paper/2018/the-impact-of-the-leverage-ratio-on-client-clearing>.

¹⁶ CFTC, Financial Data for FCMs, <https://www.cftc.gov/MarketReports/financialfcmdata/index.htm>.

¹⁷ DAT Report at 21.

¹⁸ *Id.* at 3, 54.

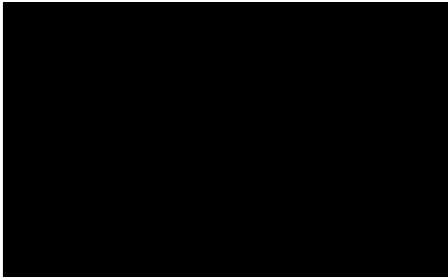
¹⁹ *Id.* at 67.

would benefit the derivatives markets by offering greater choice to customers. Moreover, derivatives exposures would be allocated among a greater number of participants, which may reduce systemic risk.

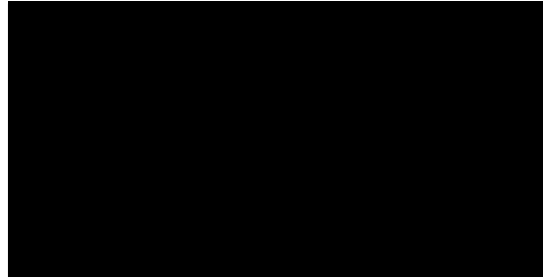
The Basel Committee on Banking Supervision recently requested input regarding whether a revision to the leverage ratio exposure measure for the treatment of client cleared derivatives would be appropriate.²⁰ We encourage the agencies to undertake a similar analysis as part of its consideration of SA-CCR.

Thank you for considering our comments. We welcome the opportunity to continue working with you and your staff on these issues.

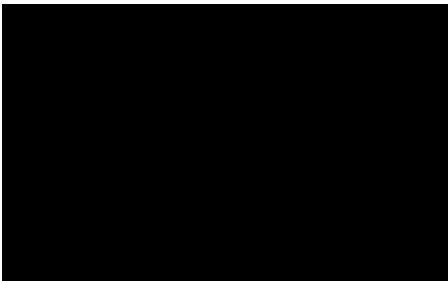
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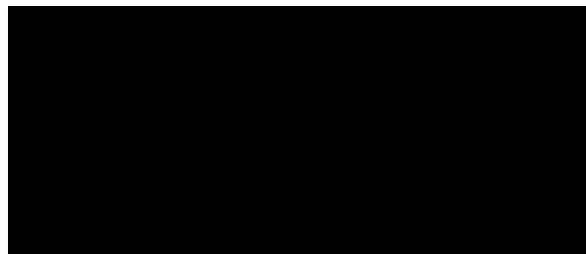
Chairman J. Christopher Giancarlo



Commissioner Brian Quintenz



Commissioner Rostin Behnam



Commissioner Dan Berkovitz

²⁰ Basel Committee on Banking Supervision, *Leverage Ratio Treatment of Client Cleared Derivatives* (Oct. 2018), available at <https://www.bis.org/bcbs/publ/d451.pdf>.