AFR Americans for Financial Reform Education Fund

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Docket ID OCC-2018-0030 (OCC); Docket No. R-1629 (Federal Reserve); RIN 3064-AE80 (FDIC)

RE: Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts

To Whom It May Concern:

Americans for Financial Reform Education Fund (AFR) appreciates the opportunity to comment on the above referenced Notice of Proposed Rulemaking (NPRM) by the Board of Governors of the Federal Reserve (the Board), the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (collectively, the Agencies). AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

This proposal would replace the Current Exposure Measure (CEM) that has been used for decades with a new Standardized Approach for Counterparty Credit Risk (SA-CCR) for determining the risk exposure of derivatives contracts. This risk exposure metric in turn determines the amount of equity capital that banks must hold against their derivatives risks.

The replacement of the CEM by the SA-CCR would significantly reduce leverage capital requirements for bank derivatives positions, which we believe would cut total capital backing derivatives books at large banks. As explained below, we do not believe that the Agencies have provided adequate analytic justification for such a capital reduction.

While the SA-CCR is depicted as conservative in the NPRM discussion, a closer examination shows that in practice it is more permissive than the CEM, particularly in its netting assumptions. It would become even more permissive if the Agencies chose to recognize collateral provided in

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

connection with cleared transactions, as the Agencies suggest they are considering. We would oppose this move.

We urge the Agencies to perform a much more intensive analysis of the costs and benefits of reducing leverage capital requirements for large bank derivatives positions before proceeding with the SA-CCR, and to consider steps to change the SA-CCR that would reduce its capital impact. Below, we expand on these points.

The SA-CCR Would Significantly Reduce Derivatives Capital Requirements at Large Banks

The Agencies state that the immediate effect of introducing the SA-CCR would be to reduce derivatives exposure metrics by seven percent (CFR 64685). Due to this exposure change, capital needed to satisfy requirements under the enhanced supplementary leverage ratio (eSLR) at the nation's largest banks would decline substantially. The SA-CCR would lead to a thirty basis point increase in measured SLR for the same amount of capital, based on reductions in the derivatives exposure metric. This is a substantial shift. It is the equivalent of crediting the six largest U.S. banks with $40 billion in additional capital for leverage ratio purposes, due solely to this seemingly technical change in how derivatives exposures are measured.[2]

It is true that measured risk-based capital would actually decline somewhat (by six basis points) due to the SA-CCR, due to both counterparty risk weighting and the specific mix of derivatives contracts affected by the SA-CCR. However, we believe that the eSLR is the most relevant binding constraint for derivatives positions at major dealers.[3] Thus the much larger eSLR increase should mean that the overall effect of the SA-CCR will be to significantly reduce total capital backing derivatives positions.

Further, it is likely that the initial impact estimate provided in the NPRM underestimates the long-term effects of the SA-CCR. As the Agencies point out, this impact estimate "does not reflect the broad definition of netting set in the proposal", which would result in additional leverage capital being credited to large banks (CFR 64685). Capital benefits will likely increase over the long term as banks optimize to the SA-CCR. Compared to the CEM, the new SA-CCR substantially down-weights capital requirements for margined derivatives and for derivatives transactions aligned with particular "hedging sets", while increasing them for un-margined derivatives and derivatives that are not aligned with hedging sets. As margin requirements cover

[2] Based on SLR exposures for Bank of America, JP Morgan, Goldman Sachs, Morgan Stanley, Citibank, and Wells Fargo at the close of 2018.

[3] FDIC officials have recently stated the eSLR is binding at the major federally insured banks of the eight U.S. G-SIBs. See Martin J. Gruenberg, Member, Board of Directors, Federal Deposit Insurance Corporation, "An Essential Post-Crisis Reform Should Not Be Weakened: The Enhanced Supplementary Leverage Capital Ratio," Peterson Institute for International Economics; Washington, DC, September 6, 2018. Available at https://www.fdic.gov/news/news/speeches/spsep0618.html. Recent work by researchers at the Commodity Futures Trading Commission indicates that the eSLR is binding for derivatives positions in particular. See Haynes, Richard et. al. "Assessing the Impact of the Basel III Leverage Ratio on the Competitive Landscape of US Derivatives Markets", CFTC Policy Brief, June 15, 2018. Available at https://www.cftc.gov/sites/default/files/About/Economic%20Analysis/oce_leverage_and_options.pdf

more of the market and banks optimize derivatives books and master netting agreements to the SA-CCR the capital reduction due to the SA-CCR will become even greater. Finally, the estimate is based on the current proposal, which permits offsets for only certain variation margin. If the final rule permits further offsets for cleared client collateral, as is suggested in the discussion, the effect on capital under the supplementary leverage ratio would be even larger.

The NPRM Does Not Properly Analyze the Effect of Lower Derivatives Capital

Despite the fact that the proposal would have a substantial impact on leverage capital requirements, the proposal contains no analysis of whether derivatives are currently overcapitalized under the CEM. Instead, the proposal simply documents that the SA-CCR incorporates more risk adjustments than the CEM. Some of this additional "risk-sensitivity" is due to the incorporation of factors urged by industry commenters (derivatives dealers) which would reduce their capital. For example on CFR 64662 the Agencies state:

> "…the proposed implementation of SA–CCR would provide important improvements to risk-sensitivity and calibration relative to CEM, resulting in more appropriate capital requirements for derivative contracts. SA–CCR also would be responsive to concerns raised regarding the current regulatory capital treatment for derivative contracts under CEM. For example, the industry has raised concerns that CEM does not appropriately recognize collateral, including the risk-reducing nature of variation margin, and does not provide sufficient netting for derivative contracts that share similar risk factors."

This is all true in the sense that the SA-CCR expands the elements of a derivatives transaction recognized in the exposure formula and updates volatility estimates. However, this is not informative as to whether the significant reduction in measured leverage exposure that is likely to occur under the SA-CCR will lead to total derivatives capital requirements that are closer to the economically optimal level than they currently are under the CEM. We would note that derivatives credit exposure under the current CEM-based method is already quite small compared to notional value. According to the latest OCC report on derivatives trading, U.S. banks register $955 billion in credit exposure for more than $200 trillion in notional derivatives held.[4] This implies that leverage capital requirements under the supplementary leverage ratio for these $200 trillion in notional derivatives would be less than $60 billion according to current eSLR requirements and less than $50 billion if current proposed cuts to the eSLR go into effect.[5]

We do not see any analysis in the Agencies current proposal or the Basel documents that is informative as to whether the eventual level of capital that would be held against derivatives positions under the SA-CCR is more economically and socially optimal than the capital that would be held under the CEM. None of the considerable literature on the overall social costs and benefits of bank capital that has been developed since the global financial crisis is used or referenced in the proposal.

Instead, the proposal appears to proceed by citing to individual elements of the SA-CCR formula as more "risk-sensitive" than the CEM. This is an entirely different question than whether, as a

[4] https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/pub-derivatives-quarterly-qtr3-2018.pdf
[5] https://www.govinfo.gov/content/pkg/FR-2018-04-19/pdf/2018-08066.pdf

whole, the SA-CCR formula will result in the optimal level of capital as compared to the CEM. It is possible that the CEM could use a simpler and more generalized formula than the SA-CCR yet still result in a level of capital that is more economically optimal. This is especially true as both of these methodologies contain numerous assumptions and approximations. All the criticisms of the CEM as unrealistic were equally true before the Global Financial Crisis of 2008, yet the CEM clearly required ***too little*** capital to be held against derivatives in 2008. This implies that arguments of "risk-sensitivity" alone are not a sufficient economic justification for moving to a new exposure metric that would likely require even less capital than the CEM.

The SA-CCR is Not Necessarily More "Conservative" Than the CEM

The analysis frequently refers to the SA-CCR as "conservative", which is puzzling given that it will result in lower capital.

The claim that the SA-CCR as more conservative than alternatives rests on two justifications. First, the SA-CCR is generally designed to be more conservative than the bank dealers own internal model methods (IMM). However, banks have strong incentives to minimize estimates of risk for capitalization purposes. Bank internal models failed to properly predict risks during the financial crisis and have been faulted in analyses conducted since then.

Second, the SA-CCR uses estimates of the volatility of individual derivatives positions that were drawn from the stressed market periods of the financial crisis, and are considerably more conservative than the volatility estimates used in the CEM. For this reason, the SA-CCR is much more conservative in its estimates of exposures for individual non-margined, non-netted derivatives positions than the CEM is. In the absence of exposure reductions for netting and margin, the SA-CCR would in fact require considerably more capital than the CEM.

However, practically speaking netting and margin are the most important determinants of derivatives exposure and capital, far more important than volatility estimates for individual positions. So the greater recognition of netting and margin benefits under the SA-CCR more than offsets the updating of volatility estimates for stress. The SA-CCR is less conservative than the CEM in how it incorporates these factors.

The Netting Provisions in the SA-CCR are Excessively Generous

We are concerned that the SA-CCR is too sanguine about the benefits of netting. The CEM calculates the potential future exposure for derivatives positions as a weighted average of the exposure incorporating netting and the exposure without netting. This is not ideal since it permits netting benefits across very dissimilar positions, but it does mean that the potential benefits of netting are capped. The SA-CCR restricts netting benefits between dissimilar positions, but calculates potential future exposure with a far greater ability to net between positions that are classed as similar according to the "hedging sets" defined in the rule.

In general, we believe it is dangerous to rely on netting to reduce derivatives exposure metrics. Netted calculations are based upon a dealer's portfolio at a point in time, and look to opportunities to net gains against losses within that portfolio. This overlooks the fact that a derivative dealer's portfolio is dynamic and that experience shows that in a stress period this

dynamic reduces the availability of netting below what had been measured before the stress. This was the experience in the 2008 bank runs on Bear Stearns and Lehman. During the run, many of the dealer's counterparties with in-the-money positions requested to novate them to another dealer, while leaving out-of-the-money positions with the dealer. Novation was standard practice, and a refusal to novate might add fuel to rumors of insolvency. As a consequence, the dealer's portfolio quickly changed, with cash being paid out on what had been a derivative liability, and with a significant decline in the eventual benefits of netting.[6]

By optimizing to the boundaries of SA-CCR hedging sets, banks may be able to reduce their exposure by even more than would be possible under the current CEM.

The Agencies Should Not Permit Recognition of Collateral in the SA-CCR As Applied to the Leverage Ratio – Questions 16 and 17

Question 16: What concerns do commenters have regarding the proposal to replace the use of CEM with a modified version of SA–CCR, as proposed, for purposes of the supplementary leverage ratio?

As discussed above, we are concerned that the shift from the CEM to the SA-CCR in calculation of the eSLR will lead to a significant decline in leverage capital requirements for derivatives, and that the Agencies have not properly assessed the risks of such a decline. One way to prevent this decline would be to apply the SA-CCR only to risk-based capital. Alternatively, the SA-CCR could be adjusted to result in a higher level of leverage exposure.

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 SA–CCR methodology. What are the pros and cons of recognizing such collateral in the calculation of replacement cost and potential future exposure?

Recognition of collateral provided in connection with cleared derivatives will of course significantly increase the extent to which the SA-CCR reduces capital requirements in connection with derivatives. We strongly oppose such recognition. The reductions in capital that result from recognizing all such collateral will be greatest at large bank clearing members, and will increase in proportion to how much clearing a bank engages in. The solvency of these large bank clearing members is critical to the stability of the financial system and the safety and soundness of the entire cleared derivatives ecosystem.

[6] Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, January 2011, see esp. pp. 287-288 & 291. See also their conclusion on Lehman, p. 343. http://fcic.law.stanford.edu/report.
Bryan Burrough "Bringing Down Bear Stearns," Vanity Fair, August 2008. http://www.vanityfair.com/news/2008/08/bear_stearns200808.
William Cohan, House of Cards: A Tale of Hubris and Wretched Excess on Wall Street, Doubleday, 2009.
Duffie, Darrell. 2010. "The Failure Mechanics of Dealer Banks." Journal of Economic Perspectives, 24(1): 51-72. https://www.aeaweb.org/articles.php?doi=10.1257/jep.24.1.51.

Over the last decade large derivatives CCPs have become central to the stability of the global financial system. Regulators have a responsibility to ensure that adequate capital backs the system of cleared derivatives. The most dangerous scenario for the failure of a significant central counterparty (CCP) is the insolvency of a major clearing member.

We are concerned that not all CCP risk that could be mutualized is currently fully capitalized. Under current rules, a small amount of risk-based capital is assessed against individual positions, and CCP members are also assessed capital against their share of the default fund. But other mutualized risks and potential exposures beyond the default fund are not capitalized. These include upward adjustments of the default fund in stressed markets, additional capital assessments beyond the default fund, and the potential need to assume positions from a defaulted member in an auction ("porting"). All of these potential events will become easier to manage if clearing members are well capitalized. By ensuring a minimum level of capital backing cleared derivatives positions, the leverage ratio helps to ensure that large clearing members will be well capitalized.

In addition, regulators should assess the operational risks of client clearing, including the margin guarantees involved, and whether minimum levels of capital are required to protect against these operational risks even in cases where cleared derivatives are well margined. Cases like the collapse of MF Global, in which customer funds were lost, should be part of this assessment.

Clearing members often argue that leverage capital will serve as a disincentive to porting positions in a stressed situation where CCPs are making recovery efforts. However, the most reasonable means to address this would be to temporarily relax leverage capital requirements in pre-defined stress situations, allowing banks to phase in additional capital over time. This would be far preferable to permitting banks to enter stressed situations with lower capital levels.

Another argument often made for offsetting collateral against capital for cleared derivatives is that clearing services are becoming excessively concentrated due to the capital expense of clearing. However, the benefits of reducing leverage capital requirements will be overwhelmingly concentrated among large existing clearing banks, not among smaller new entrants. We believe the infra-marginal effect in lowering capital at banks already providing clearing services will dwarf any marginal benefit to new entrants.

Finally, regulators should also be cognizant of the conceptual issues with incorporating risk mitigants such as margin into leverage ratio calculations. This would set a potentially dangerous precedent by blurring the distinction between leverage and risk-based capital.

The Agencies Should Perform a More Detailed Analysis of Whether the Derivatives Capital Reduction Under the SA-CCR is Justified

We urge the Agencies to perform a fuller analysis of the likely long-run reduction in derivatives capital under the SA-CCR and whether this reduction is in fact economically justified. Such an analysis should include:

- A more complete analysis of the effects of the SA-CCR on overall capital backing derivatives positions at U.S. G-SIBs, highlighting potential capital reductions due to the

impact of the SA-CCR on leverage capital and whether such reductions are justified from the perspective of the overall social benefits and costs of bank capital.

- An analysis of the effectiveness of margining practices alone in addressing risks to the solvency of derivatives dealers in stressed markets, including both the effectiveness of margin in the 2008 crisis and the actual changes in margining practices since that time. This analysis should focus on whether margin alone is adequate to offset the risks that would occur from having lower levels of capital backing large derivatives books, including e.g. the risk of operational losses due to failure in margining arrangements.

- An analysis of the effectiveness of netting arrangements in addressing risks to the solvency of derivatives dealers in stressed markets. This analysis should draw on the experience of the 2008 crisis to address whether derivatives exposures can shift rapidly in stressed markets in ways that render netted values inaccurate, and also whether netting assumptions are durable legally in the event of significant counterparty default.

- An analysis of whether and how banks could optimize their netting arrangements to the boundaries of the "hedging sets" contained in the SA-CCR in order to reduce capital requirements under the SA-CCR by more than initially predicted, and whether such regulatory arbitrage could increase risk in the system as compared to the current CEM limitations on netting benefits. The Agencies should also make clear the correlation assumptions on which hedging sets are based and whether these assumptions are likely to hold in stressed markets.

We realize that a complete examination along these lines is challenging. However, we believe it is necessary to conduct a fuller analysis of the extent to which this proposal would reduce overall derivatives capital, and the overall economic costs and benefits of such a reduction. The current proposal appears to us to rely excessively on industry claims that current derivatives exposure metrics are "inappropriate" in ways that increase dealer derivatives capital requirements. It reflects too little independent analysis by the Agencies themselves of what the appropriate overall level of capital backing derivatives positions should be.

Even if such an analysis concludes that cutting derivatives capital requirements is not justified, this does not necessarily mean a return to the CEM. The same methodologies used in the SA-CCR could easily be recalibrated to produce higher levels of derivatives capital requirements.

Thank you for the opportunity to comment on these Proposed Rules. If you have questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,

Americans for Financial Reform Education Fund