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Craig Phillips
Counselor to the Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Phillips:

On behalf of FIA, I would like to thank you for taking the time to meet with our Board on July 12. It was very useful to discuss with you a range of important issues impacting the cleared derivatives markets as Treasury undertakes the vital task of completing its review for the Presidential Executive Order 13772 on Core Principles for Regulating the United States Financial System.

We previously submitted FIA's *Roadmap to smarter regulation & healthier markets* to Secretary Mnuchin on May 11. Ahead of the publication of the next Treasury Financial System Report on Capital markets and our meetings with Treasury officials, FIA would like to take this opportunity to provide some additional perspectives on the liquidity impact of inappropriate capital regulations, and on clearing house ("**CCP**") risk. These issues address a number of the *Core Principles* in the President's February 3rd Executive Order, namely making regulation efficient, effective, and appropriately tailored, addressing systemic risk and market failures, and enabling American companies to be competitive with foreign firms in domestic and foreign markets.

The two sets of issues we will cover in this letter are:

I. Current capital regulations are adversely impacting our hedging markets; and
II. CCP Resilience and Risk.

I. Current capital regulations are adversely impacting our hedging markets

As we outlined in our Roadmap report, certain capital rules are placing extreme burdens on many market participants, including commercial end-users who had nothing to do with the financial crisis. It is becoming clear that the cumulative impacts and costs of these rules are making it more challenging for market participants to access these markets and hedge risk, and consequently reducing liquidity in key derivatives markets.

Reform is needed in four particular areas of capital regulations that are adversely impacting hedging in the client cleared derivatives markets:

A. Offsetting client margin under the Leverage Ratio;
B. Treating cleared variation margin as settlement;
C. Implementing a revised counterparty credit risk model; and
D. Recalibrating the shock that is applied to exchange traded derivatives in CCAR's large counterparty shock scenario.

A. Offsetting client margin in the Leverage Ratio

FIA wants to reiterate our appreciation for including in the first Treasury Report a recommendation that the Supplementary Leverage Ratio have a deduction from the leverage exposure denominator for initial margin for centrally cleared derivatives. We have recently undertaken further analysis to determine the impact such an offset would have on overall bank capital requirements. We estimate that granting such an offset would only reduce the amount of leverage exposure across the industry by 0.22%. This confirms statements made by acting Commodity Futures Trading Commission ("**CFTC**") Chairman Christopher J. Giancarlo that granting such an offset, while imperative for the clearing businesses of these banks, would have an insignificant impact on capital requirements overall.

We want to further explain why providing an offset for client initial margin for clearing makes sense and will improve the efficiency and competitiveness of U.S. derivatives markets, which will lower costs for businesses and consumers.

The leverage ratio is designed to require banks to hold capital against actual exposures to loss, yet the current construct fails to consider existing market structure explicitly designed to mitigate such exposures. Unlike making loans or taking deposits, guaranteeing client trades exposes the bank to losses only to the extent that the margin collected is insufficient to cover the clients' clearing obligations. To make sure that margin is available to absorb losses, it is posted in the form of either cash or extremely safe and liquid securities and the majority of the margin is then passed on to the CCP. Furthermore, there are strictly enforced rules to ensure that client margin is available for the limited purpose of guaranteeing the customers' trades and is therefore segregated away from the bank's own money, if not completely outside of the bank's control.

One of the essential attributes of central clearing is the ability for customers to move their positions and their collateral out of a clearing firm at any time. This is more than a matter of customer choice. When a clearing member is in distress, customers must have the ability to swiftly and securely move their positions and their collateral to another clearing firm. This is what allows for continuity in the functioning of cleared derivatives markets in spite of the failure of one or more major clearing firms, as we all saw during the crisis of 2008. The leverage ratio, however, substantially changes the economics of clearing and dramatically increases the risk that the porting process will fail, thereby intensifying the pro-cyclical pressure on markets. We are deeply concerned that clearing members subject to the leverage ratio will be reluctant to acquire client positions from a failing clearing member, especially in times of system-wide stress, because the ported clients' segregated margin would increase the clearing member's capital requirements at a time when firms would already face capital and liquidity challenges. Without the ability to transfer client positions in an orderly manner, the clearinghouses will be forced to liquidate customer positions, intensifying market stress at exactly the wrong moment.

Effectively, the inability to recognize the segregation of client initial margin in the leverage ratio inappropriately increases the capital cost of client clearing, thereby undermining one of the key tenets of financial reform following the crisis, which is to utilize the safeguards of central clearing for standardized derivatives contracts. This harms farmers seeking to manage commodity price fluctuations, commercial firms wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. A recent survey of corporate finance professionals found that increased bank capital charges are viewed as the primary source of increased costs for business.[1]

B. Treating cleared variation margin as settlement

Under CFTC and CCP rules, variation margin paid daily to clearing members for cleared derivatives is considered to be settlement of the exposure. However for capital purposes, U.S. prudential regulators have not allowed banks to treat cleared OTC swap variation margin as settlement.

Specifically, under the Current Exposure Method ("**CEM**"), capital calculations may be reduced by 1% of notional for interest rate swap trades with greater than 5 years to maturity if the variation margin of the trades settle and reset daily.[2] However U.S. clearing members have not been allowed to treat variation margin in such a way. This is despite the fact legally, the payment of variation margin from CCPs to clearing members is considered to be settlement of the exposure. Based on the CEM PFE tables, interest rate derivative trades of this maturity that "settle" benefit from a PFE reduction of 67%--delivering significant RWA savings. While some non-U.S. client clearers have implemented this approach, to date, U.S. clearers await prudential regulatory authorization before implementing this Basel rule.

This decision by the U.S. prudential regulators increases costs for clearing members, and consequently for businesses that use derivatives to hedge their risks. The U.S. prudential regulators should amend this decisions and, consistent with Basel Committee standards, determine that cleared variation margin must be treated as the settlement of an exposure.

C. Implementing a revised counterparty credit risk model

We also discussed the need for the U.S. to move to the Standardised Approach to Counterparty Credit Risk ("**SA-CCR**") to replace CEM for certain capital calculations. CEM, introduced in the U.S. in 1988, has not kept pace with the evolution of the derivatives markets. It generally overstates derivatives exposures due to the conservative assumptions incorporated in the methodology such

[1] https://www.uschamber.com/report/financing-growth-the-impact-financial-regulation
[2] 12 CFR 217.34 for Federal Reserve, equivalent provisions for other prudential regulators.

as restricted netting and lack of differentiation between margined and unmargined trades. As you may know, the Basel Committee has adopted SA-CCR for use in the Risk-Weight Assets ("**RWA**"), in replacement of CEM.

In the Basel Committee on Banking Supervision's release of SA-CCR in 2014, it stated that its objectives were to "devise an approach that is suitable to be applied to a wide variety of derivatives transactions (margined and unmargined, as well as bilateral and cleared) and addresses the deficiencies of CEM".[3]

One of the examples of how CEM does not reflect the true risks of clearing is its allowance of limited netting. When a trader executes and clears offsetting standardized trades via the same clearing house, that risk is naturally compressed and eliminated. However, CEM operates in a "gross" notional environment, calculated at the level of each client. No netting, compression or reduction of notional is possible between different accounts. Consequently, the CEM framework significantly overstates capital requirements for clearers relative to the underlying risk in the portfolios they clear for clients.

While SA-CCR was intended to better reflect the underlying risk of cleared derivatives, there are several fundamental flaws in Basel's formulation, including over-calibration and lack of collateral recognition. We encourage the U.S. prudential regulators to expeditiously propose the adoption of SA-CCR in a way that addresses these shortcomings and we look forward to a robust comment period before adoption to ensure the rule achieves its intended outcomes, especially as they relate to clearing activity.

D. Recalibrating the large counterparty shock to exchange traded derivative counterparties

In the context of CCAR stress testing, clearing member banks with large trading operations are subject to CCAR's global market shock ("**GMS**") and large counterparty default scenario, which assumes both a six-month equivalent move of market prices with no ability to collect additional collateral or hedge, and the default of the bank's largest trading counterparty. This scenario is unrealistic for any derivative product, but is particularly inappropriate in the case of exchange traded derivatives, which have exceptional price transparency and liquidity, and for which market convention is to liquidate positions of clients that fail to meet margin requirements within just a few days.

As a result of the overly conservative calibration of the GMS shock and the unpredictable and sometimes directional nature of client cleared positions, it is possible for a clearing member client, such as a pension fund with highly liquid exchange-traded positions, to become a CCAR bank's largest (and thus assumed defaulting) counterparty. This introduces undue, and often material, volatility in stress test results and capital planning that is completely disconnected from risk and how market stress has historically unfolded.

[3] Basel Committee on Banking Supervision, *The standardized approach for measuring counterparty credit risk exposures* (March 2014, rev. April 2014), *available at* http://www.bis.org/publ/bcbs279.pdf.

This is yet another reason driving clearing member banks away from providing clearing services when clearing is encouraged as a way of bringing greater transparency and safety to derivative markets. The U.S. prudential regulators should recalibrate the CCAR GMS and large counterparty default shock to be more realistic and coherent with severely adverse scenario, especially in the case of exchange-traded derivatives. Such changes could account for the clearing member's ability to close out and liquidate a defaulting client's portfolio within a few days. Failure to recalibrate CCAR will likely result in clearing members reducing services to large directional hedgers such as pension funds, insurance companies and corporates.

Overall impact of current capital regulations

We are concerned that left unchanged the capital rules will undermine recent financial regulatory reforms by limiting the amount of client clearing banks will conduct, especially for hedgers who result in disproportionately high leverage exposures, thereby reducing access to clearing and limiting hedging opportunities for end users. This will in turn lead to a smaller and less diverse set of clearing participants, as well as higher concentration risk among remaining clearing firms. CFTC data shows that since 2002 the number of Futures Commission Merchants that clear futures products has fallen from 106 to 54—a drop of almost 50%.[4] Since 2014, five major banks have announced their departure from the swaps clearing business. Today the top five clearing firms hold more than three-quarters of the client margin for cleared swaps in the U.S., concentrating this demand among only a handful of clearing members.

In the European Union[5] and other major jurisdictions, regulators have implemented or proposed to implement SA-CCR, along with an offset for client cleared initial margin under the leverage ratio. The failure of the U.S. regulators to adopt this approach means U.S. banks and businesses will be at a competitive disadvantage compared with their counterparts in the EU.

The negative impacts to the real economy are significant and we strongly encourage the new administration to avoid these risks by revising the capital rules to accurately reflect the true exposure and risks of client clearing for derivatives.

[4] As at March 2017, representing FCMs that hold customer funds. Source: CFTC, data available at https://fia.org/fcm-tracker.

[5] See the European Commission's Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures reporting and disclosure requirements and amending Regulation (EU) No 648/2012

II. CCP Resilience and Risk

In our discussions with you, we were pleased to see that the Treasury is reviewing carefully the issue of CCP risk. While FIA has supported efforts to bring more standardized products into clearing, we also appreciate that such centralization of risk requires policymakers to carefully review how CCPs manage risk for their clearing members, clients and the markets in general. FIA has previously published papers with recommendations to improve CCP risk arrangements, including the publication of a CCP Risk Position Paper in April 2015.[6] We support the substantial improvements that have been made in CCP risk management practices over the last decade, but believe there is still work to do to ensure CCPs are sufficiently sound and resilient given their systemic importance to the financial system. The CPMI-IOSCO Report on *Resilience of central counterparties (CCPs): Further guidance on the PFMI* ("**CPMI-IOSCO Guidance**"),[7] published last month, includes a number of improvements to CCP risk management practices that should be implemented by the U.S. regulatory agencies.

We would like to raise six CCP risk issues that should be addressed to better protect the financial system in the event of a potential systemic shock or market failure:

A. The need for a review and improved transparency of CCP initial margin models;
B. That CCP's own capital contributions need to increase;
C. A range of improvements that are needed to CCP Governance;
D. That clearing members should not be responsible for non-default losses;
E. That CCP should be required to provide claims in return for clearing member contributions to CCP recovery and resolution; and
F. The need for increased safeguards around the use of Variation Margin Gains Haircutting.

A. Initial Margin Models

It is vital that initial margin requirements are effective, transparent and predictable to all participants. Initial margin is the foremost risk mitigation technique in a clearing member default scenario to avoid broader losses, systemic consequences and ultimately the need for recovery and resolution. If a CCP calculates and calls for sufficient initial margin, the likelihood of needing to utilize the default fund or enter into a recovery scenario is greatly reduced.

While we believe substantial work has been undertaken in recent years to improve global standards for CCP Recovery and Resolution, there has been less focus on ensuring that initial margin models remain sufficient. FIA believes there should be further structured governance around initial margin models, bringing together the quantitative and risk management experience and resources of clearing members, CCP regulators and individual CCPs. Through a structured process of transparency, disclosure and periodic analysis, we believe that CCP risk committees, CCP management, clearing member risk management and regulators can be consistently and

[6] https://fia.org/sites/default/files/content_attachments/FIAGLOBAL_CCP_RISK_POSITION_PAPER.pdf
[7] https://www.bis.org/cpmi/publ/d163.pdf

appropriately appraised of the challenges presented by any one product and any one clearing service.

Regulators should regularly review initial margin models across CCPs to ensure that similar products have consistent initial margin requirements. Work should be undertaken globally to compare initial margin models to ensure CCPs are not competing to reduce their initial margin requirements, and that initial margin levels have been sufficient to deal with recent stressed market environments. The substantial amount of trade data regulators are collecting should assist in this comparison.

B. CCP's Own Capital Contributions need to increase

CCP's Own Capital Contributions ("Skin in the Game") are a means to align the interests of CCPs with Participants. FIA's clearing members believes that a CCP's contribution to the default fund should be an amount that is material to such CCP and also aligned with the amount of risk in the CCP's system. Skin in the Game should be segregated and fully funded for such purposes, and CCPs should have sufficient capital on hand to replenish their capital contributions on the same timeline (usually within a matter of days) and for the same number of defaults that clearing members are required to make such replenishments. Skin in the Game should be used ahead of any non-defaulting clearing member resources in the default waterfall. An appropriate level of skin in the game will incentivize the CCP and its shareholders to engage in prudent risk management both prior to and during a stress event as they would share in any resulting losses. It therefore better aligns the motivations of clearing participants on the one hand and the CCP and its equity holders on the other.

In addressing the related topic of resolution planning under Title II of the Dodd-Frank Act, both the Commodity Futures Trading Commission and the Federal Deposit Insurance Corporation have acknowledged the importance of holding the owners and management of a financial company responsible for their failures. *See, e.g.*, Commission Letter No. 16-61, fn. 11 *quoting* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, 76615 (December 18, 2013) ("The FDIC must resolve the covered financial company in a manner that holds owners and management responsible for its failure accountable – in order to minimize moral hazard and promote market discipline – while maintaining the stability of the U.S. financial system.").

In response to CPMI-IOSCO's Consultative Report "Resilience and recovery of central counterparties (CCPs): Further guidance on the PFMI" (**"CPMI-IOSCO Consultative Report"**), a joint Trade Associations response (**"Trade Associations' CPMI-IOSCO Response")**[8] recommended that CPMI-IOSCO provide additional guidance regarding the specific quantum of resources to be placed ahead of non-defaulting clearing member's mutualized resources. Many Trade Association members support requiring an amount equal to a percentage of the default fund (e.g., ten percent), an amount equal to the largest default fund from a group of affiliated clearing members, a risk-based skin in the game model, or the higher of these amounts.

[8] https://fia.org/articles/fia-welcomes-proposed-guidance-central-counterparty-risk-and-pushes-more-transparency

The CPMI-IOSCO Guidance recognised that "the amount and characteristics … of a CCP's own contribution to absorb potential losses resulting from a participant default and the custody and investment of participant assets can enhance confidence among participants with respect to the risk management at the CCP and with respect to the alignment of interests between the CCP and its participants". The guidance also stated that "In determining the amount and characteristics of its own contribution, the CCP should consider the results of engagement with direct and indirect participants and other relevant stakeholders." The CFTC and SEC should ensure that U.S. CCPs have sufficient own capital contributions to ensure interests are aligned, and that the CCPs have engaged with stakeholders to determine the amount of such contributions.

In addition, a CCP's parent company and/or equity holders should bear losses alongside clearing members when loss recovery tools are used. This ensures CCPs are properly incentivized to exercise prudent risk management and focus on CCP risk management.

C. CCP Governance

Given the growing systemic importance of CCPs, it is critical that any material rule changes have a public comment period. Under CFTC Regulation 40.6, CCPs may self-certify rules with the CFTC and in 10 days, that rule becomes final unless the CFTC issues a stay due to novel or complex issues. If a stay is issued, the Commission provides a 30-day comment period.

The CFTC rules are intended to provide extra protections for rules relating to systemically important CCPs. Pursuant to Regulation 40.10, the systemically important CCPs must file a rule change with the CFTC *and* Federal Reserve and the regulators have *60 days* to review the rule. However, if the rule is stayed due to novel or complex issues, there is <u>no required public comment period</u>. Although there should be extra protections for such CCPs, a critical public comment period is not required. Proposed rule changes that the CFTC or Federal Reserve deem raise complex and novel issues should be published for public comment, particularly those rules relating to systemically important CCPs.

In addition to requiring needed public comment periods for rules, CCPs also should be required to consult with clearing members more often. For instance, over the past few years, CCPs have been changing their rulebooks to grant themselves substantial new powers for use during a CCP Recovery process. While we are generally supportive of these increased powers as a way to reduce the likelihood of a CCP being moved into resolution, we believe that there have not been sufficient governance safeguards put in place in the event a CCP decides to use these additional powers.

In particular, given the substantial impact to clearing members from the use of Variation Margin Gains Haircutting ("**VMGH**"), we believe it is vital that there be appropriate safeguards in place to ensure these tools are used appropriately. When invoking tools that impact loss distributions after the exhaustion of funded and unfunded resources, CCPs should be required to consult not only the Risk Committee but also all members.

D. Non-Default Losses

In order to avoid a CCP default, CCPs must have sufficient capital and/or insurance to cover all non-default losses. Non-default losses that are under the exclusive control and governance of the CCP, such as operational, legal, general business, cyber, credit and liquidity risks, should not be borne by the clearing members. Clearing members should not have any responsibility mutualizing these losses as only the CCP is able to quantify and manage these risks. Potential moral hazard issues arise for CCP management if clearing members have responsibility for losses that are within the CCP's sole control. Clearing member contributions to a CCP's financial resources should not be available to absorb a CCP's non-default losses. CCPs and their shareholders must bear the entire risk of non-default losses that are exclusively within their control. It is crucial to consider and stress-test each potential non-default loss scenario to ensure available funding (*e.g.,* CCP capital or other funding that would be available with certainty upon the occurrence of the non-default loss). In the event funding is insufficient, the CCP's parent company and/or equity holders should bear losses.

E. Claims in return for clearing member contributions to CCP recovery and resolution

If a CCP prior to resolution, or a resolution authority in resolution, exercises loss allocation tools beyond the CCP's funded default fund contributions and clearing member assessments up to the applicable cap (*e.g.,* VMGH) and/or any involuntary position allocation or tear-up tools, then participants suffering losses as a result of the exercise of such additional loss and position allocation tools must retain claims for the amount of their total losses. These loss allocation tools go beyond the traditional CCP rulebook and are being implemented solely to effectuate CCP recovery and resolution. A recovered CCP should not provide dividends to its shareholders before those that helped to recovery the CCPs receive compensation for the recovery.

Additionally, inclusion of these tools in the CCP rulebooks that form the contractual relationships between CCPs and clearing members is fundamentally different than how recovery or resolution would proceed in the case of non-CCP financial entities. In the case of a non-CCP recovery or resolution, counterparties of the relevant financial entity would receive claims for any losses they suffer as part of recovery or resolution and the financial entity would not have the ability to "contract out" of such claims.

Claims should:

- Be senior to existing CCP equity in the creditor hierarchy;
- Not be extinguishable in resolution or post-resolution prior to satisfaction or conversion into an instrument of equivalent value; and
- Entitle claimholders to future CCP accumulated earnings or returns in excess of regulatory capital requirements until they are paid in full. During such time, strict limitations should apply to any dividend payments by both the CCP and its parent and dividends to any remaining pre-existing equity should be prohibited.

If feasible under the applicable legal framework, CCPs and resolution authorities may consider evidencing such claims by nil paid preference shares or similar instruments, issued either as true shares or contractual rights. Such claims would have absolutely no value unless the CCP's recovery or resolution were successful and the CCP returned to profitability. These claims would ensure appropriate mutualisation of both losses in a recovery or resolution scenario and future profits.

F. Variation Margin Gains Haircutting

In the remote scenario that CCP default waterfall resources are inadequate to absorb default-related losses, loss allocation tools may be a necessary last resort in the furtherance of clearing service continuity. While no loss allocation tools are ideal, FIA believes that VMGH is preferable over other loss allocation tools such as initial margin haircutting or additional assessments (over and above capped assessments).

However, we believe that the current implementation of VMGH at a number of CCPs provides insufficient safeguards to the use of this powerful tool. As it stands, the use of VMGH is likely increase financial instability in a time of market disruption. We therefore believe regulators need to ensure that VMGH is only used in limited circumstances, and in such a way that its use does not add additional risk to the financial system.

FIA's view on the use of VMGH was most recently represented in the Trade Associations' CPMI-IOSCO Response, where we stated the following:

> *While some members support VMGH [Variation Margin Gains Haircutting] as a loss allocation tool in recovery with certain limitations others do not. Members who do not support the use of VMGH in recovery believe that "comprehensive loss allocation" beyond funded (i.e., default fund) and unfunded (i.e., capped assessments) mutualized resources would not be appropriate outside of resolution unless remaining resources come from the CCP or its parent. These members maintain that if a CCP exhausts all of its resources and cannot obtain additional resources from its parent, then the CCP is in principle unable to pay its obligations when they come due, and therefore should be placed into resolution. Other members who do not support VMGH in recovery believe that its use could have knock-on effects in an already distressed market, particularly if clearing members causing the four largest losses (assuming "Cover 2" plus one assessment), have already defaulted. One member does not support any use of VMGH in recovery or resolution. Members who support VMGH in recovery believe that it is an effective and efficient loss allocation tool that facilitates a CCP-led recovery, provided that it is subject to strict regulatory oversight and constraints (e.g., quantitative limits) determined on an ex ante basis. These members also believe that VMGH should be used only at the very end of the default "waterfall."*

FIA believes that VMGH and the use of partial tear-ups is preferable to the forced allocation of contracts, as forced allocation does not correctly allocate risk to those members who bring the relevant risk to the CCP and are thus better placed to manage it.

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We appreciate Treasury's careful consideration of these important market and risk issues. If you have any questions regarding the letter, feel free to contact me or Jacqueline Mesa, Senior Vice President, Global Policy at jmesa@fia.org or 202-772-3040.

Most respectfully,

Walt L. Lukken

Walt L. Lukken
President and CEO