



November 22, 2017

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

**Re: Supplemental Information Regarding Proposed Agency Information  
Collection Activities (FR Doc. 2017–17939)**

Dear Ms. Misback:

The Futures Industry Association (“FIA”) and the International Swaps and Derivatives Association (“ISDA”)<sup>1</sup> are writing to supplement our letter of October 11, 2017, which expressed our deep concerns with the proposed changes by the Board of Governors of the Federal Reserve System (“Board”) to the mandatory Banking Organization Systemic Risk Report form (“FR Y-15”) to add to the Complexity and Interconnectedness indicators of the G-SIB Surcharge any over-the-counter (“OTC”) derivatives transaction in which a U.S. global systemically important banking organization (“G-SIB”), acting as agent for its client’s trade with a central counterparty (“CCP”), guarantees the client’s performance to the CCP (the “Proposal”).

As a threshold matter, we reiterate that the Proposal could *increase* systemic risk and have an adverse impact on financial stability. As we discussed in our October 11, 2017 letter, the Proposal would treat derivatives clearing – which has significantly reduced complexity and interconnectedness in the financial system – as equivalent to entering into bilateral derivatives, which would be an overly blunt way of measuring systemic risk that would not recognize meaningful differences between those activities. The Proposal would substantially and unnecessarily increase the capital requirements attributable to client clearing for OTC derivatives, and thereby undermine U.S. banking organizations’ incentives to engage in client clearing. As a result, the Proposal is counter to the post-crisis policy goals of incentivizing central clearing and ensuring that capital standards do not unnecessarily discourage or penalize central clearing. As we noted in our prior letter, these policies are built on the assumption that there will be an adequate number of clearing members that are able and willing to provide clients and end users’ access to clearing services and cleared products to hedge their risks, and we remain concerned that this assumption would prove incorrect if the Board finalized the Proposal.

To help the Board further understand the significant negative impact the Proposal would have on U.S. G-SIBs and their clients based on the current state of the OTC derivatives markets, this supplemental letter describes the recent growth in client clearing; sets forth data demonstrating

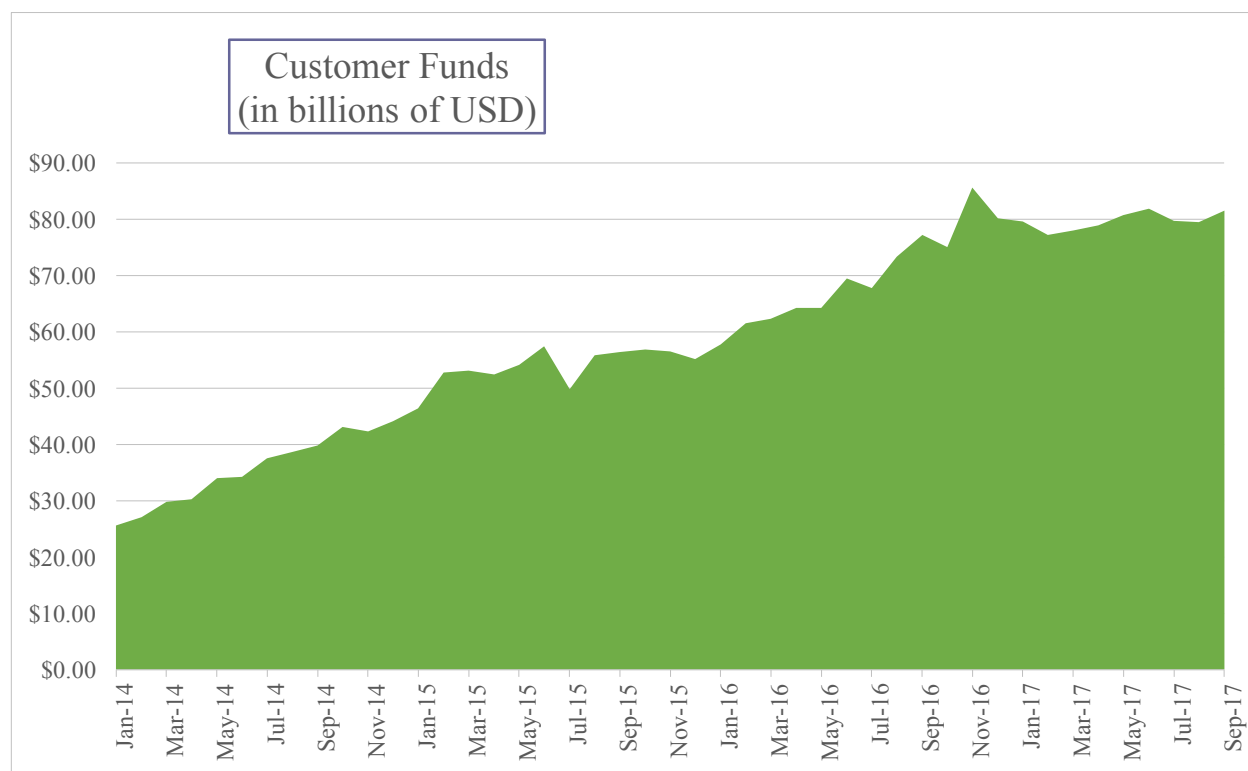
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<sup>1</sup> See the Annex to this letter for a description of FIA and ISDA.

the predominance of the agency clearing model in the United States; and explains how client clearing differs from “house” trading in cleared OTC derivatives.

## I. Growth in Client Clearing

OTC derivatives clearing has grown significantly in recent years, reflecting post-crisis policies established in favor of mandatory clearing of standardized OTC derivative contracts, including in the Pittsburgh G20 Commitments of 2009,<sup>2</sup> which Title VII of the Dodd-Frank Act translated into binding legal requirements in the United States. Commodity Futures Trading Commission (“CFTC”) data shows that clearing activity for swaps through futures commissions merchants has grown more than threefold since 2014:<sup>3</sup>



A number of factors have driven the growth of client clearing:

- As discussed in more detail in our October 11, 2017 letter, after the financial crisis, U.S. and global regulators adopted policies favoring central clearing because, as Board

<sup>2</sup> We note that the G20 commitments also provide that “[n]on-centrally cleared contracts should be subject to higher capital requirements,” implying that centrally cleared derivatives contracts should be subject to *lower* capital requirements. The Proposal is flatly inconsistent with this mandate.

<sup>3</sup> Based on CFTC data as of September 30, 2017, calculated using total customer funds for swaps as a proxy for total clearing activity. See FIA FCM Tracker, FCM Customer Funds, Customer Funds in Swap Accounts, available at <https://fia.org/fcm-customer-funds>.

Governor Jerome H. Powell has said, “[c]entral clearing serves to address many of the weaknesses exposed during the crisis by fostering a reduction in risk exposures through multilateral netting and daily margin requirements as well as greater transparency through enhanced reporting requirements. Central clearing also enables a reduction in the potential cost of counterparty default by facilitating the orderly liquidation of a defaulting member’s positions, and the sharing of risk among members of the CCP through some mutualization of the costs of such a default.”<sup>4</sup> Clients also benefit from central clearing because they incur less exposure to their clearing members, including in the event of failure of the clearing member, than they would to a counterparty bank in a bilateral trade.

- Due to these benefits, and consistent with the Pittsburgh G20 Commitments and the requirements of the Dodd-Frank Act, in November 2012 the CFTC issued its first clearing mandate for covered swaps, including four classes of interest rate swaps and two classes of credit default swaps.<sup>5</sup> Compliance was phased in over time, with Category 1 Entities (swap dealers, major swap participants, and active funds) required to comply for swaps entered into by March 11, 2013, Category 2 Entities (commodity pools, private funds, and persons predominately engaged in the business of banking or in activities considered financial in nature) required to comply by June 10, 2013, and all other entities required to comply by September 9, 2013. Similar requirements have been implemented globally.
- Dealer desks at banking organizations have higher capital requirements for bilateral trades than for cleared trades. For instance, bilateral trades attract higher risk weights than cleared trades that face a CCP.
- U.S. regulators have imposed margin requirements for uncleared swaps with the apparent intent to further incentivize banking organizations and their clients to migrate to cleared products where possible.<sup>6</sup>
- The operational workflows of clearing are much more streamlined. Margin movements are minimized, reconciliations are simplified, and additional services such as compression are easier to facilitate on a cleared basis.
- Clients often prefer cleared products for all of the foregoing reasons.

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<sup>4</sup> Federal Reserve Board Governor Jerome H. Powell, Central Clearing and Liquidity, Speech at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Chicago, Illinois (June 23, 2017), available at <https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm>.

<sup>5</sup> See 77 Fed. Reg. 74,284 (Dec. 13, 2012).

<sup>6</sup> See 81 Fed. Reg. 636, 689 (Jan. 6, 2016) (CFTC stating that “the final rule’s robust margin requirements for uncleared contracts may create incentives for participants to clear swaps, where available and appropriate for their needs.”).

Despite this overall migration to clearing, five major banks have announced their departure from the swaps clearing business since 2014, due in substantial part, we believe, to disproportionately high capital requirements that have made derivatives clearing uneconomical.<sup>7</sup> We fear that, if finalized, the Proposal could lead to additional departures by clearing firms and reverse some of the momentum that is moving the markets toward further central clearing of OTC derivatives. It is wholly unnecessary for the Board to cause this result in order to capture the risks arising out of client clearing activity within its capital requirements, because the Board's risk-based capital requirements, the Supplementary Leverage Ratio, and the Size indicator of the G-SIB Surcharge already impose substantial – and in some cases excessive – capital requirements for client cleared OTC derivatives transactions.

## II. The Agency Clearing Model in the United States

Globally, banking organizations clear derivatives for their clients under two models. Under the agency model, a banking organization acts as agent for its client, which enters into the derivative directly with a CCP. The banking organization typically guarantees the client's performance to the CCP, but not the CCP's performance to the client. Under the principal-to-principal model, a banking organization enters into equal and offsetting trades as principal directly with the client and the CCP.<sup>8</sup> The Complexity and Interconnectedness indicators of the U.S. G-SIB Surcharge currently include client clearing activity conducted under the principal-to-principal model,<sup>9</sup> but not under the agency model (unless the banking organization guarantees the CCP's performance to the client).

Our October 11, 2017 letter described how the Proposal would place U.S. G-SIBs at a competitive disadvantage to their competitors by including client cleared transactions cleared by a U.S. G-SIB clearing member on the agency model within the Complexity and Interconnectedness indicators while the Basel Committee on Banking Supervision's reporting instructions for the international G-SIB Surcharge assessment exclude such transactions from the Complexity indicator.

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<sup>7</sup> Deutsche Bank: <https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655>; Nomura: <https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de>; RBS: <http://uk.reuters.com/article/uk-rbs-primetimeservices-divestiture-idUKKBN0DY0PU20140519>; State Street: <https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-business-citing-new-rules>; BNY Mellon: <http://www.pionline.com/article/20131210/ONLINE/131219993/bny-mellon-closes-us-derivatives-clearing-business>.

<sup>8</sup> Similarly to the agency model, in the principal-to-principal model, the banking organization typically does not take on liability for the CCP's performance to the client.

<sup>9</sup> See, e.g., Board of Governors of the Federal Reserve System, Instructions for Preparation of Banking Organization Systemic Risk Report, Reporting Form FR Y-15, at p. D-1 (“When acting as a financial intermediary (i.e., where the banking organization is a counterparty to both the client and the CCP), report the notional amounts associated with each contract (i.e., the contract with the CCP and the contract with the client).”).

We further note that the Proposal would disproportionately impact U.S. G-SIBs *even if* the Basel Committee also added client cleared transactions on the agency model to the international version of the Complexity indicator. CFTC data shows that six U.S. G-SIBs conduct a total of 76 percent of all agency swaps client clearing activity through futures commission merchants, with eight non-U.S. G-SIBs conducting a total of 23.6 percent of such activity.<sup>10</sup> Five of the top six clearing members for cleared swaps are U.S. G-SIBs.<sup>11</sup>

To give a sense of the scale of the agency model, LCH has reported to FIA and ISDA that it clears 90 percent of client cleared OTC interest rate swaps globally, as measured by notional amount. Of this client activity, 92 percent of the notional is cleared under the agency model. The remaining 8 percent of notional is cleared under the principal-to-principal model. And of the OTC interest rate swaps cleared through LCH under the agency model, 36 percent of clients (measured by number of clients) are domiciled outside the United States. Similarly, ICE reports that 98.7 percent of the notional amount of credit default swaps cleared through ICE globally have been cleared under the agency model.<sup>12</sup>

Clearing predominantly takes place under agency model for several reasons:

- CFTC regulations for the clearing of futures and swaps in the United States are predicated on the agency model.<sup>13</sup> Clearing for U.S. participants must be done through futures commission merchants, which are required to clear under the agency model.<sup>14</sup>
- Two major cleared swaps CCPs, CME and ICE Clear Credit, offer swaps clearing solely under the agency model in the United States. As these CCPs do not support the

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<sup>10</sup> Based on CFTC data as of September 30, 2017, calculated using total customer funds held for swaps as a proxy for total clearing activity. See FIA FCM Tracker, FCM Comparison Table, available at <https://fia.org/fcm-comparison-table>. Non-U.S. G-SIB designations are based on the Financial Stability Board's November 2016 list.

<sup>11</sup> Based on CFTC data as of September 30, 2017, calculating using total customer funds held for swaps as a proxy for total clearing activity. See FIA FCM Tracker, FCM Comparison Table, available at <https://fia.org/fcm-comparison-table>.

<sup>12</sup> See ICE, Total Open Notional Cleared CDS (accessed Nov. 22, 2017), available at <https://www.theice.com/clear-credit> (reporting \$31.69 trillion in aggregate gross notional of client cleared credit default swaps cleared through ICE Clear Credit, which uses the agency model, and \$0.41 trillion in aggregate gross notional of client cleared credit default swaps cleared through ICE Clear Europe, which uses the principal-to-principal, as of November 17, 2017). The cleared interest rate swaps market is many times larger than the credit default swaps market, as measured by gross notional outstanding. Compare LCH, Volume and Notional Outstanding Totals (accessed Nov. 22, 2017), available at <https://www.lch.com/services/swapclear/volumes> (reporting \$143.6 trillion in gross notional outstanding of cleared interest swaps at LCH as of November 21, 2017) with ICE, Total Open Notional Cleared CDS (accessed Nov. 22, 2017), available at <https://www.theice.com/clear-credit> (reporting \$1.64 trillion in gross notional outstanding of cleared credit default swaps at ICE as of November 17, 2017).

<sup>13</sup> See, e.g., 17 C.F.R. § 39.12(b)(6).

<sup>14</sup> See 7 U.S.C. § 6d(f)(1).

principal-to-principal model, clients seeking access to products cleared at these CCPs must have those products cleared under the agency model.

- In early 2012, the CFTC issued final rules adopting the legal segregation with operational commingling (or “LSOC”) model for cleared swaps conducted under the agency model of clearing, effective November 2012.<sup>15</sup> The simplicity of this account structure, and customer protections available thereunder, encouraged market participants to clear their swaps under the CFTC-regulated agency model.

The predominance of the agency model for the clearing activity of U.S. G-SIBs underscores the substantial capital impact the Proposal would have on their businesses.

### **III. Differences Between Client Clearing and House Trading**

U.S. G-SIBs run their client clearing businesses entirely separately from their “house” trading operations (which conduct client-facilitating trading activity). In fact, banking organizations are subject to strict conflict of interest requirements that separate client clearing activity from house activity. CFTC conflict of interest rules guard against undue influence of a banking organization’s sales/trading unit over the clearing unit, including decisions to offer agency clearing services and the pricing and risk parameters under which services are offered.<sup>16</sup> Client cleared trades are not visible to personnel responsible for house trading, and the client clearing business is similarly not aware of the identities of its clients’ execution counterparties. Clients are free to execute with one institution and to clear with another, which most clients do.

Importantly, U.S. G-SIBs evaluate the returns of the client clearing and house trading businesses separately, in light of the amount of capital attributed to each business and the risk inherent in each business. This means that, for a G-SIB to justify continuing its client clearing business, the business needs to meet appropriate return on equity targets in its own right, which is significantly more challenging for it to do when capital requirements for clearing are set disproportionately high given the low-risk nature of the business.

From a risk management perspective, house trading desks monitor the market risk of their own positions, and maintain strict value at risk (“VaR”) limits on the amount of market exposure they are allowed to take. They also need to monitor the credit risk that they take against a client’s positions. By contrast, clearing businesses do not take market risk on client positions, meaning that clients bear any profit or loss attributable to market moves. Clearing businesses’ risk management focuses on credit risk, including by imposing credit limits on clients to ensure the businesses’ exposures to clients stay within risk tolerances, because clearing businesses do not

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<sup>15</sup> See 77 Fed. Reg. 6,336 (Feb. 7, 2012).

<sup>16</sup> CFTC rules require, among other things, that swap dealers and futures commissions merchants establish information partitions and policies and procedures that reasonably ensure that swap dealer personnel cannot interfere with or attempt to influence the decisions of client clearing personnel to offer clearing services to a particular customer, and that prevent business trading unit personnel from supervising, controlling, or influencing client clearing personnel. See 17 C.F.R. §§ 1.71(d)(1)-(2); 23.605(d)(1)-(2).

incur market risk directly. Due to these differences, client clearing is a significantly less complex activity than house trading.

House trading desks are able to manage the notional associated with their positions by clearing them through a CCP. This enables house trading desks to net down notionals that would result from facing multiple clients in bilateral trades down to a much lower number for equivalent cleared trades, where the house trading desks face a single counterparty, the CCP. Client clearing businesses, by contrast, are unable to net down notional across clients, as each client's positions must be maintained separately. Client clearing businesses therefore have much less control over cleared notional amounts than house trading desks do. As a result, despite having no market risk, a client clearing business may have larger notionals than a house trading desk that engages in a comparable amount of trading activity. For this reason, and the reasons discussed throughout this supplemental letter and our October 11, 2017 letter, adding client cleared transactions to the Complexity and Interconnectedness indicators of the G-SIB Surcharge, as the Proposal would do, would impose disproportionately high capital requirements for client clearing activity.

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Board of Governors of the Federal Reserve System  
November 22, 2017

We thank the Board for its consideration of the matters discussed in this supplemental letter. Please contact Jacqueline Mesa, Senior Vice President of Global Policy at FIA, at 202-466-5460, or Christopher Young, Head of U.S. Public Policy at ISDA, at 202-683-9339, if you have any questions.

Respectfully Submitted,



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President and Chief Executive Officer  
Futures Industry Association



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cc: Shagufta Ahmed, Office of Information and Regulatory Affairs, Office of Management and Budget



## **Annex - Descriptions of the Associations**

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).