United States House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets, Securities and Investments

Legislative Proposals Regarding Derivatives

Statement of Walter L. Lukken

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Introduction

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, thank you for reviewing the regulatory treatment of derivatives and for allowing me to offer FIA's strong support for bipartisan legislation, H.R. 4659.

I am the President and Chief Executive Officer of FIA. 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 to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members help reduce systemic risk in global financial markets.

I appreciate having the opportunity to discuss capital and margin matters impacting the derivatives industry and to express our strong support of H.R. 4659, legislation that would provide an offset for initial client margin in the supplementary leverage ratio. H.R. 4659 was introduced by Chairman Blaine Luetkemeyer, and Representatives Frank Lucas, David Scott, Tom O'Halleren and Filemon Vela are original co-sponsors of this bipartisan legislation. Enacting H.R. 4659 will provide needed relief to agricultural and other end-users who are facing rising costs and fewer choices in the cleared derivatives markets and will ensure that U.S. clearing banks can compete on a level playing field relative to their foreign competitors who are receiving an offset from their regulators.

The offset for initial client margin Chairman Luetkemeyer included in H.R. 4659 has enjoyed bipartisan support in the House Committee on Agriculture for years. FIA has appreciated the advocacy of former Chairman Frank Lucas, Chairman Michael Conaway and Ranking Member Collin Peterson. Additionally, bipartisan chairmen of the Commodity Futures Trading Commission, Democratic Chairman Timothy Massad and Republican Chairman Christopher Giancarlo, have both indicated their support for this reform to the supplementary leverage ratio.

Nature and Importance of Central Clearing

Central clearing ensures that parties to a transaction are protected from the failure of a buyer or seller to perform its obligations, thus minimizing the risk of a counterparty default. The central clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members, which also guarantee the performance of their clients to make good on their transactions. To protect against default by a client, clearinghouses require that all transactions are secured with a pool of appropriate margin. This pool of margin is often called "initial margin," because it is first collected at the outset of the transaction to form a buffer against intraday losses, and is distinguished from "variation margin," which is a payment made at least daily based on short-term price movements.

Clearing members, acting as agents for their clients, collect initial margin and segregate it away from their own funds as required by the Commodity Exchange Act. They have long performed this function for futures clients, who have historically been required to clear their transactions. More recently, the Dodd-Frank Act in the U.S. and the European Market Infrastructure Regulation (EMIR) in Europe extended the clearing requirement beyond futures and options to certain over-the-counter swaps. As such, more products are being cleared and the role of the clearing member has expanded. Despite this expansion, over the ten-year period between December 2007 and December 2017, the number of active clearing firms in the U.S. has decreased from 84 to 55.

While there are several factors contributing to the consolidation of clearing members, today I want to focus on how Basel III capital requirements for prudentially regulated clearing members are decreasing clearing options for end-user clients who use futures and cleared swaps to manage their business risks. These capital requirements have made it difficult for many bank-affiliated clearing members to offer clearing services to their clients—a result that is at odds with recent efforts by the Group of 20 nations (G-20) to increase the use of clearing as a counterparty risk mitigation tool.

At issue is the supplementary leverage ratio under Basel III, a measurement tool used by global banking regulators to determine the amount of leverage that should be backed by capital. Unfortunately, the supplementary leverage ratio fails to properly recognize that client margin posted to a bank-affiliated clearing member belongs to the client, is provided by the client to offset the clearing member's exposure to the client's default, and actually reduces the clearing member's economic exposure. As stated by CFTC Chairman Giancarlo "Applying the SLR to clearing customer margin reflects a flawed understanding of central counterparty (CCP) clearing"[1]. As a result, the supplementary leverage ratio significantly overstates the clearing member's actual economic exposure, which artificially inflates capital requirements, and in turn, disincentivizes banking organizations from providing clearing services to clients.

Background - Supplementary Leverage Ratio

One of the central reforms to bank capital requirements following the financial crisis was the decision by the Basel Committee on Bank Supervision (Basel Committee) to implement a new type of leverage ratio on a global basis. In January 2014, the Basel Committee finalized its leverage ratio standard, which it later revised in December 2017. The Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have implemented the Basel supplementary leverage ratio in the United States (the SLR) and added an "enhanced" supplementary leverage ratio for global systemically important banking organizations, or eSLR. The SLR is similar to the international Basel supplementary leverage ratio standard, but the eSLR imposes a quantitatively higher capital requirement than the international standard, which exacerbates the leverage ratio's distortive effects and makes it all the more important to get the standard right in the United States. The Basel supplementary leverage ratio, SLR, and eSLR all took effect as binding requirements at the beginning of this year.

The Basel supplementary leverage ratio was intended to be "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements."[2] FIA supports the goals of stronger capital requirements and recognizes that leverage ratios can be an important backstop to keep systemic leverage in check. But we also believe that leverage ratios should accurately reflect the actual economic exposures of a banking organization, which the Basel supplementary leverage ratio fails to do in the case of a centrally-cleared derivative transaction.

Unlike traditional leverage ratios, which require a bank to maintain a minimum amount of capital relative to its on-balance sheet assets, the Basel supplementary leverage ratio also requires capitalization for off-balance sheet exposures, including those arising from a bank-affiliated clearing member's guarantee of client obligations to clearinghouses in futures, options, and other derivative transactions.

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[1] www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 - *Remarks of Acting Chairman J. Christopher Giancarlo*, May 10, 2017

[2] Basel Committee on Banking Supervision - *Basel III leverage ratio framework and disclosure requirements*, January 2014.

Importantly, in a centrally-cleared derivative transaction, the clearing member collects margin from its client to ensure that its economic exposure arising out of this guarantee to the clearinghouse is reduced, if not eliminated entirely. This structure is critical to making the markets work, because it allows the clearing member to offer the client access to the cleared derivatives markets' risk management tools. That is, an end user that utilizes the futures market to hedge its business risks is required to clear such a transaction through a clearinghouse, and in order to do so it must post margin through a clearing member for the purpose of offsetting the clearing member's economic exposure to the client.

Unlike making a loan or taking a deposit, guaranteeing a client's trades exposes the bank to losses only if a client defaults and to the extent that the margin collected from the client is insufficient to cover the client's obligations. Indeed, to make sure that initial margin is always available to absorb losses arising from the client's transaction, Commodity Futures Trading Commission (CFTC) rules require that it be posted in the form of either cash or extremely safe and liquid securities such as U.S. Treasuries. Moreover, Congress, through the Commodity Exchange Act, has required the clearing member to treat the margin as belonging to the client and to be segregated from the clearing member's own funds. In other words, these are client funds provided specifically by the client to offset the clearing member's exposure arising from its obligation to pay the clearinghouse on behalf of the client. Such client margin should therefore be considered as an offset in determining the bank's exposure. That is, the very nature of initial margin posted by a derivatives client is solely exposure-reducing with respect to the clearing member's cleared derivatives exposure.

Given these longstanding regulatory requirements and the exposure-reducing function of margin, it stands to reason that the Basel supplementary leverage ratio should recognize segregated client margin as reducing a bank's actual economic exposure to a clearinghouse for purpose of measuring exposure under the leverage ratio. But the Basel leverage ratio does not recognize this plainly exposure-reducing effect of margin. As a result, we believe the exposure measure under the leverage ratio is artificially inflated relative to a bank's actual economic exposure in a client-cleared derivatives transaction. This real and significant overstatement of actual economic exposure results in unwarranted capital costs for banks and their clearing member affiliates. Having examined the profiles of a group of firms, the FIA estimates that aggregate leverage exposure of firms would be 80 percent higher without an offset for margin from the leverage ratio[3].

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[3] https://fia.org/sites/default/files/2016-07-06_FIA_Comment_Letter_Basel_Committee_Leverage_Ratio.pdf , *FIA Response to Basel Leverage Ratio Consultation Regarding the Proposed Calculation of Centrally Cleared*

Negative Consequences

The Basel supplementary leverage ratio is undermining recent financial regulatory reforms by discouraging banks from participating in the clearing business, thereby reducing access to clearing and limiting hedging opportunities for end users. Despite an overall migration to clearing in recent years, 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.[4]

Left unchanged, the failure of the Basel supplementary leverage ratio to recognize the exposure-reducing effect of segregated margin will continue to substantially and unnecessarily inflate the amount of required capital that will need to be allocated to the clearing businesses within banking organizations. Because derivatives clearing is traditionally a very low risk, low return business, banks are less likely to take on new clients for derivatives clearing and instead are allocating their capital to higher risk, higher returning activities. As stated by Governor Powell: "such a ratio can have perverse incentives if it is the binding capital requirement because it treats relatively safe activities, such as central clearing, as equivalent to the most risky activities."[5] The US implementation of the Basel supplementary leverage ratio is creating precisely this perverse incentive.

Increases in required capital also greatly increase costs for end users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers.[6] As a result, market

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Derivatives Exposures Without Offset for Initial Margin and its Impact on the Client-Clearing Business Model, July 6, 2016

[4] 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-primeservices-divestiture-idUKKBN0DY0PU20140519; State Street: https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-businesscitingnew-rules; BNY Mellon: http://www.pionline.com/article/20131210/ONLINE/131219993/bny-melloncloses-us-derivatives-clearing-business.

[5] https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm - *Speech by Governor Jerome H. Powell on Central Clearing and Liquidity*, June 23, 2017

[6] *See, e.g.*, *SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers* (June 30, 2016), available https://www.sifma.org/resources/submissions/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-

participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks. As stated by Chairman Giancarlo, "we witness diminishing market access for smaller market participants, who will have a much tougher time laying off risk during stressed market conditions."[7]

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. The lack of an offset within the Basel supplementary leverage ratio would severely limit the ability of banks to purchase portfolios of cleared derivatives from other distressed clearing members—including distressed banks. This will leave clearinghouses and clients of any failing clearing member with an added strain during an already stressful situation. Moreover, as the levels of margin required by clearinghouses increase in times of stress, Basel supplementary leverage ratio capital costs will correspondingly increase, aggravating the constraint on portfolio purchases. Such a constraint on providing liquidity to stressed markets would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.

The Basel supplementary leverage ratio is also likely to continue to result in market exit by derivatives clearing members that no longer find the business economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end user access to the risk mitigation benefits of central clearing. As stated by CFTC Chairman Massad: "if some clearing members choose to limit customers, or get out of the clearing business altogether, that may make it harder to deal with the next time a clearing member defaults"[8].

Finally, I note that FIA represents bank and non-bank clearing members and I can assure you that this situation is not one that will benefit non-bank clearing firms. In fact, many non-bank clearing members – those clearing members not subject to Basel III capital requirements – have weighed in to explain their inability to assume the clearing volume currently done through banks due to their own balance sheet constraints. Moreover, these non-bank clearing members are concerned about the broader market impacts that may arise as a result of fewer

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leverage-ratio-framework/ (sixty percent of asset managers surveyed reporting an increase in clearing fees for interest rate swaps).

[7] www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 - *Remarks of Acting Chairman J. Christopher Giancarlo*, May 10, 2017

[8] http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-38 - *Remarks of Chairman Timothy Massad before the 2016 P.R.I.M.E. Finance Annual Conference*, January 25, 2016

access points to the cleared derivatives markets. This harms farmers seeking to manage commodity price fluctuations, commercial companies wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. The negative impacts to the real economy are significant.

The consequences I have just outlined are fundamentally inconsistent with market regulators' global policies designed to enhance the appropriate use of centrally cleared derivatives. In various speeches, CFTC Chairman Giancarlo and former CFTC Chairman Massad have consistently expressed concern about the Basel supplementary leverage ratio's treatment of initial margin for client cleared derivatives and the resulting declining population of clearing members as well as systemic concerns related to the portability of client positions and margin funds.

<u>U.S. Economic Competitors Offering Offset</u>

Our nation's economic competitors have taken steps to provide their countries' end-users, clearing members, and derivatives markets by implementing an offset for initial client margin within their domestic leverage ratios. Financial regulators in the United Kingdom have announced they will do so, and legislation has been introduced in the European Union to provide banks with an offset, as well.[9]

Should the U.S. fail to similarly provide an offset within the supplementary leverage ratio and enhanced supplementary leverage ratio, U.S. banking organizations and their clients will be placed at a significant disadvantage to their overseas competitors. Our regulations should be designed not to inhibit economic activity and risk-mitigating hedging being conducted in the United States, so long as U.S. banks have adequate capital.

<u>Insignificant Impact on Overall Capital Levels</u>

FIA supports strong capital requirements that ensure banks and the financial system are adequately protected. The offset provide by H.R. 4659 would have a negligible impact on banks' overall capital levels, reducing them by approximately less than 1 per cent[10]. This minimal impact on overall capital levels does not justify the harmful consequences on the

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[9] In December 2017, the Basel Committee said it will take two years to study the impact of the leverage ratio on client clearing, and together with other international standard-setting bodies, launched a survey of market participants to evaluate those effects.

[10] http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement062017 - *Statement of Acting Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting*, June 20, 2017

cleared derivatives markets caused by the SLR's failure to recognize the exposure-reducing effect of initial margin.

And to be clear, my testimony has nothing to do with trades undertaken by banks on their own account. Our concerns solely relate to risk-mitigating trades that banks clear as agents on behalf of their clients.

Conclusion

FIA strongly supports the efforts of Chairman Luetkemeyer and his colleagues to provide an offset for initial client margin in the supplementary leverage ratio. The SLR's failure to recognize the exposure reducing nature of initial client margin harms end-users who utilize the cleared derivatives markets to hedge. Failure to provide such an offset will saddle end-users with higher clearing costs and fewer choices of those offering clearing services. FIA has determined that enacting an offset would have an inconsequential impact on overall capital levels. Furthermore, our economic competitors have already offered or plan to offer an offset for client margin in the very near future, placing U.S. market participants at a disadvantage relative to their foreign competitors at a time when we should be encouraging as much economic activity in the U.S. as possible.