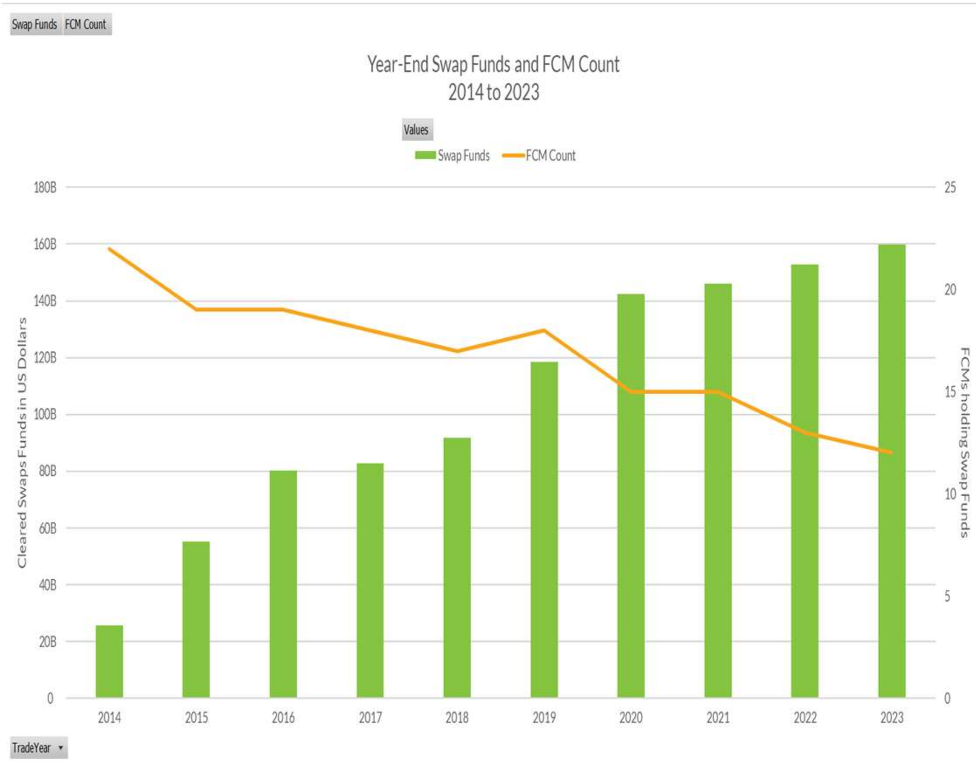
Proposed Capital Rules and Impact to Clearing

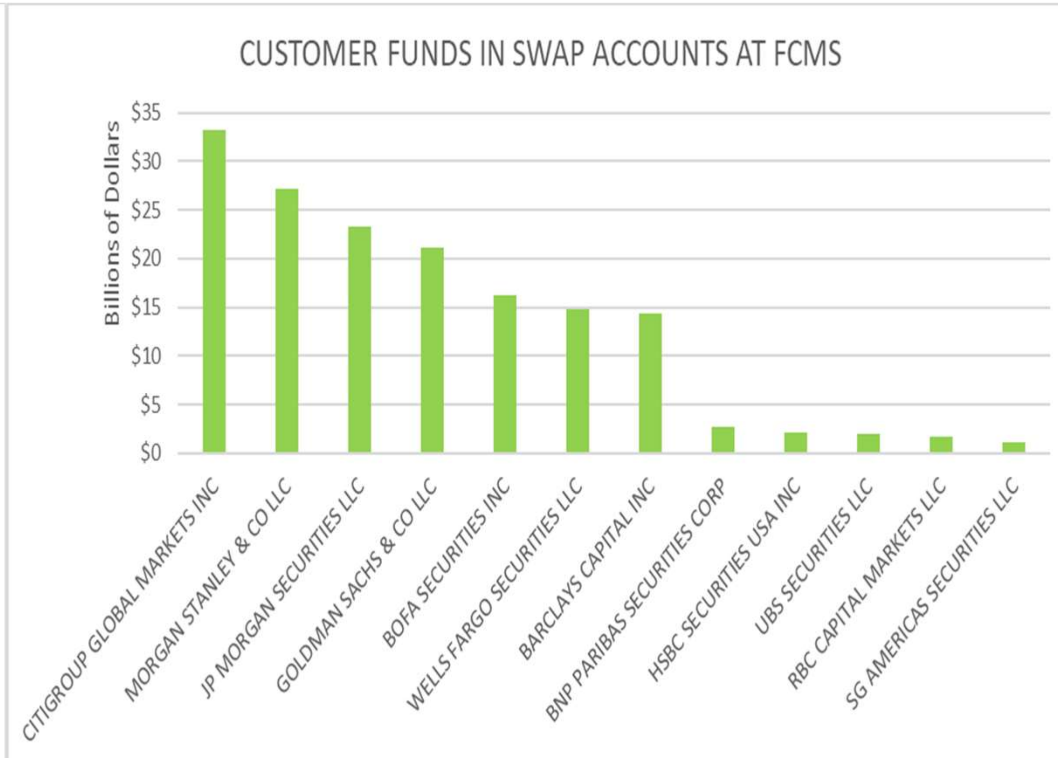
November 2023

Centrally Cleared Derivatives Market Challenges

- In the US, firms that clear derivatives for clients must be registered with the Commodity Futures Trading Commission as "Futures Commission Merchants" (FCMs).
- According to 2023 data from the CFTC, there are 47 registered FCMs providing customers with access to exchange traded derivatives markets, a roughly 50% decline during the past twenty years.
- The majority of remaining FCMs are bank holding company subsidiaries.
- Additionally, there are a limited number of banks that provide clearing services for over-the-counter (OTC) derivatives. When Dodd-Frank Act reforms became effective in 2014, there were twenty-two FCMs providing OTC clearing. Today, there are only twelve clearing banks, with seven of these banks comprising 94% of the market.

Swap Clearing: Rising Demand, Falling Supply, Dominated by US BHCs

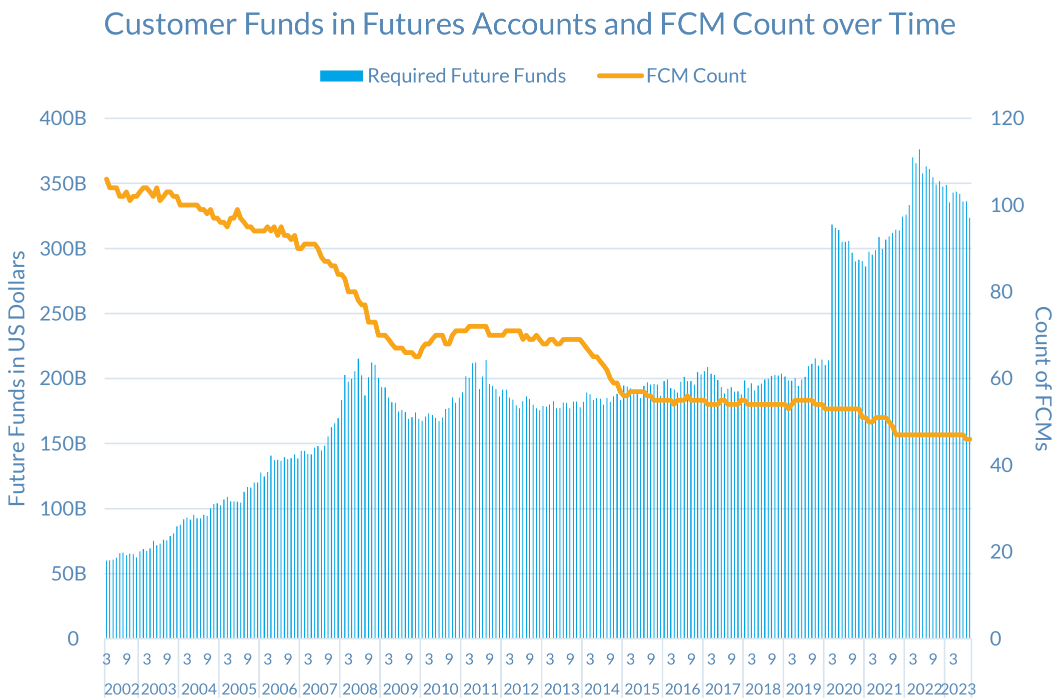




Source: FIA FCM Tracker

Data as of July 2023

Futures Clearing: Rising Demand, Shrinking Capacity and Number of FCMs



Rank	CFTC-Registered FCM	Customer Funds
1	JP MORGAN SECURITIES LLC	$46,819,594,299
2	GOLDMAN SACHS & CO LLC	$45,760,387,169
3	MORGAN STANLEY & CO LLC	$35,829,547,649
4	BOFA SECURITIES INC	$32,985,926,322
5	SG AMERICAS SECURITIES LLC	$25,189,846,019
6	CITIGROUP GLOBAL MARKETS INC	$21,899,091,370
7	BARCLAYS CAPITAL INC	$18,304,875,880
8	MIZUHO SECURITIES USA LLC	$9,894,498,472
9	UBS SECURITIES LLC	$8,438,953,357
10	ADM INVESTOR SERVICES INC	$8,116,170,463
11	INTERACTIVE BROKERS LLC	$7,540,545,721
12	MAREX CAPITAL MARKETS INC	$7,317,208,104
13	RJ OBRIEN ASSOCIATES LLC	$6,213,082,286
14	BNP PARIBAS SECURITIES CORP	$6,078,828,984
15	STONEX FINANCIAL INC	$5,927,627,214
16	WELLS FARGO SECURITIES LLC	$5,807,489,893
17	HSBC SECURITIES USA INC	$4,410,309,005
18	WEDBUSH SECURITIES INC	$4,150,656,647
19	MACQUARIE FUTURES USA LLC	$3,946,327,863
20	RBC CAPITAL MARKETS LLC	$3,892,668,346

Source: CFTC FCM Financial Condition Reports. Note: Customer funds include funds held in both Section 4(d) and Part 30 accounts. Fund ranking as of August 2023.

Concerns about the GSIB Surcharge and Basel III Endgame Proposals

- **GSIB Surcharge Proposal *(Fed Only Proposal)***
  - The proposal would add OTC client cleared leg under the agency model to the Complexity and Interconnectedness Indicators of the GSIB Surcharge.
    - This proposal would significantly increase capital requirements for the OTC client clearing activities of US GSIBs.
    - Since the inception of the GSIB Surcharge in the US, its Complexity and Interconnectedness indicators have been excluded.
- **Basel III Endgame Proposal *(Joint Fed/FDIC/OCC Proposal)***
  - **Credit Valuation Adjustment**
    - Inclusion of client clearing in the CVA framework is unnecessary as the only client-related credit risk that the clearing member faces is risk of client default, which is already captured in existing counterparty credit risk framework.
  - **Operational Risk**
    - The Endgame Proposal’s approach to calculating the services component of operational risk would serve as a tax on clearing; doesn't distinguish risk and is based on gross fees.
  - **Counterparty Credit Risk**
    - The requirement for an investment grade company to be publicly traded to get a lower risk weight harms end-users, many of which are not publicly traded and will receive higher risk weight.
    - SA-CCR should be revised to permit netting of STM/CTM client cleared transactions.
    - The inability to decompose non-linear trades under SA-CCR is problematic for listed options.
    - The proposed increased risk weights for exposures to foreign banks could make it more difficult for banks, or their foreign affiliates, to offer client clearing services outside the US.

The Bottom Line

- If adopted in current form, the GSIB Surcharge and the Basel III Endgame Proposals will exacerbate capacity challenges facing the clearing ecosystem today while making central clearing more expensive to end users.
- Sufficient clearing capacity is important to enable orderly market function and increase the likelihood of successful porting in times of stress, especially in the event of clearing member default.
- Even if end-users are not engaged in the OTC cleared space, the effects of the increased costs for clearing and the reduced capacity for clearing will impact them.
- Ironically, one of the cited reasons for the failure of Silicon Valley Bank was the fact it stopped utilizing derivatives to hedge interest rate risk in order to reduce costs.
- The fear of increased prices and lower capacity will raise costs or create lack of access for hedging for end users such as farmers, ranchers, energy producers, pension funds and insurance companies. This will result in higher costs for food, energy, and insurance costs as well as reduced pension returns.
- If end-users do decide to pay more to continue hedging, the costs will ultimately be passed on to US consumers in the form of higher prices for food, energy and mortgages.