



January 16, 2024

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Attention: Comments/Legal OES (RIN 3064-
AF29)
Federal Deposit Insurance Corporation
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Chief Counsel's Office
Attention: Comment Processing
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400 7th Street, SW, Suite 3E-218
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Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity (OCC Docket ID OCC-2023-0008; Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29)

Dear Sirs and Madams:

The Futures Industry Association (“FIA”)¹ is writing to express our serious concerns with the proposed capital treatment of client derivatives clearing activities in the federal banking agencies’ proposal to change the capital regulations that apply to large banking organizations (the “Endgame Proposal”).²

Board of Governors of the Federal Reserve System (“Board”) Chair Jerome H. Powell has stated that global regulators “have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing.”³ The Endgame Proposal, along

¹ FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. 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.

² 88 Fed. Reg. 64,028 (Sept. 18, 2023).

³ 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>.

with the Board’s proposed changes to the capital surcharge that applies to U.S. global systemically important banking organizations (the “Surcharge Proposal,”⁴ and together with the Endgame Proposal, the “Proposals”) would contravene that mandate by significantly raising capital requirements for derivatives clearing without providing evidence that current capital requirements for this activity are inadequate. As described in further detail below, a quantitative impact study of our member firms⁵ shows that the two Proposals would collectively increase the capital required to engage in client clearing activities by more than **80 percent**, and the Endgame Proposal would, on its own, increase the capital required to engage in client clearing activities by more than **22 percent**.

Figure 1: Capital Requirement Attributable to Six U.S. G-SIBs’ Client Clearing Activity as of June 30, 2023⁶

	Capital Requirement Expressed in Dollars (billions)	Percentage Increase in Capital Requirement
Current U.S. Standardized Approach	\$8.96	N/A
Net Increase from Endgame Proposal	\$2.01	22.4%
Net Increase from Surcharge Proposal	\$5.20	58.1%
Total Net Increase from Proposals	\$7.21	80.5%

The Endgame Proposal would therefore strongly discourage banks from engaging in client clearing activities, which could increase costs for clearing for end users, decrease end users’ access to clearing services, and increase systemic risk by reducing capacity for porting of a failed clearing member’s client positions in times of stress. We are very concerned about the absence of any apparent cost-benefit analysis that considers these important negative impacts of the Proposals on systemic stability and on end users such as agricultural businesses, insurance companies, and pension funds.

Part I of this letter provides background on client derivatives clearing activities and describes why such activities are fundamentally low risk for clearing members, enable clients to hedge their risks, and make the financial system more sound, and therefore should not be subject to further incremental capital requirements. Part II sets forth our recommendations for changes to the proposed regulatory capital treatment of client clearing activities in the Endgame Proposal. Specifically, we recommend that the agencies should, within any final rule:

⁴ 88 Fed. Reg. 60,385 (Sept. 1, 2023).

⁵ The data collection and analysis for this quantitative impact study was conducted by the GARP Benchmarking Initiative (GBI)®, a division of the Global Association of Risk Professionals® (GARP). GARP®, a nonpartisan, non-profit corporation, is the world’s leading professional association for risk managers, dedicated to the advancement of the profession through education, research, and the promotion of best practices. GARP does not lobby, take advocacy positions, or engage in any advocacy related to the data it collects and analyzes.

⁶ Our calculation methodology is described further below in this letter. *See* n. 16, 31, and 33.

- Exclude derivatives exposures arising from client clearing from the Credit Valuation Adjustment (“CVA”) framework;
- Revise the Endgame Proposal’s approach to calculating the services component of operational risk, such as by permitting a netting of expenses from revenues;
- Revise the Standardized Approach to Counterparty Credit Risk (“SA-CCR”) to permit netting of settled-to-market (“STM”) and collateralized-to-market (“CTM”) transactions together even when they are not “cleared transactions,” a term that the capital rules define to exclude a clearing member’s exposure to its client;
- Withdraw the Endgame Proposal’s changes that would prohibit the decomposition of nonlinear indices within SA-CCR;
- Omit the Endgame Proposal’s requirement for an investment grade obligor to be publicly traded to be eligible for a lower risk weight; and
- Maintain the current standardized approach’s minimum risk weight of 20 percent for exposures to depository institutions and foreign banks and adopt the Basel Committee’s framework for short-term exposures to banks.

These recommendations are described in greater detail below. Finally, the Appendix to this letter answers specific questions that the agencies have asked in the Endgame Proposal preamble.

I. Regulators Encourage Client Clearing Because It Reduces Systemic Risk in the Aggregate and Is a Low-Risk Activity for Clearing Members

A. Global and U.S. policies are intended to incentivize client clearing

A wide variety of businesses across many different sectors, including agricultural businesses, insurance companies, and pension funds, use derivatives to reduce their risks from various economic activities.

To promote the continued, long-term availability of this beneficial hedging activity, global regulators have promoted central clearing of derivatives as a key element to financial reform because it greatly reduces risk in the financial system that could arise from financial institutions’ role in providing their clients access to swaps and futures. The Pittsburgh G20 commitments of 2009 establish a clear policy that mandatory clearing of certain derivatives is essential to improving risk management and promoting financial stability. Among other elements of this policy, the G20 commitments endorse lower capital requirements for cleared derivatives.⁷ This policy is notable because elements of the proposed expanded risk-based

⁷ The G20 commitments 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. See Leaders’ Statement, The Pittsburgh Summit, September 24-25 2009, available at <https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf>.

approach, including the CVA risk framework, would require the same level of capital for cleared derivatives and non-centrally cleared derivatives.

The Dodd-Frank Act translates the G20 policy goal of promoting central clearing into binding requirements in the United States. Since the passage of Dodd-Frank, there have been significant regulatory and structural changes to the OTC derivatives markets. Today, an overwhelming majority of OTC derivative products are centrally cleared through regulated clearinghouses and a growing number of derivatives are traded on regulated trading venues,⁸ bringing more transparency and oversight to these markets than ever before, and substantially reducing their complexity.

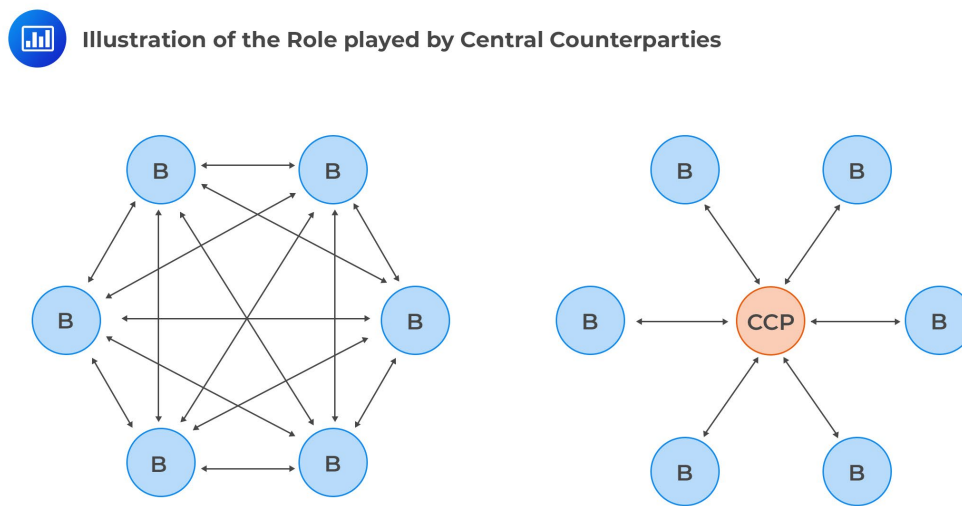
B. Client clearing decreases systemic risk

As depicted in Figure 2, central clearing helps to mitigate systemic risk and provides transparency by replacing the complex web of bilateral ties between market participants with a more transparent central counterparty (“CCP”) system:⁹

⁸ See Bank for International Settlements, OTC Derivatives Statistics at End-June 2023 (Nov. 16, 2023), available at https://www.bis.org/publ/otc_hy2311.htm (“The share of credit default swaps cleared by central clearing counterparties reached 70% for the first time at end-June 2023. The similar share for interest rate derivatives has hovered close to 80% since 2019.”).

⁹ The SEC recently cited the benefits of central clearing when it adopted final rules to require the central clearing of U.S. Treasury securities. See SEC Final Rule, Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities, available at <https://www.sec.gov/files/rules/final/2023/34-99149.pdf>; SEC Chair Gary Gensler, Statement on Final Rules Regarding Treasury Clearing (Dec. 13, 2023), available at <https://www.sec.gov/news/statement/gensler-statement-treasury-clearing-121323> (“While central clearing does not eliminate all risk, it does lower it. First, clearinghouses do so by sitting in the middle and reducing all the risks amongst and between counterparties. They also provide multi-party netting, which helps lower the overall margin (collateral) needed to be posted in the system. Further, central clearing reduces risks through the robust rules of the clearinghouses themselves, including for the collection of initial and variation margin.”).

Figure 2: Depiction of Effect of Clearing on Ties Among Market Participants



Central clearing through a CCP substantially reduces the universe of counterparties that are exposed to a clearing member as compared to bilateral derivative arrangements, and thus results in the clearing member being less interconnected with other firms.¹⁰ Clients have lower 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, because in a cleared OTC derivative transaction conducted in the agency model,¹¹ the client’s counterparty is the CCP.¹²

¹⁰ See Froukelien Wendt, *Central Counterparties: Addressing their Too Important to Fail Nature*, IMF Working Paper, p. 6 (Jan. 2015), available at <https://www.imf.org/external/pubs/ft/wp/2015/wp1521.pdf> (“The establishment of a CCP reduces the interconnectedness of banks. A CCP guarantees the performance of open positions despite the failure of one of the clearing members. In that sense a CCP that is well designed and capitalized insulates counterparties from one another. In its role of firewall a CCP can be considered a prudential tool to reduce the interconnectedness among banks.”).

¹¹ Functionally, the same is true under the principal model of clearing, as market-standard contractual arrangements relieve the clearing member of its obligation to make a client whole if the CCP defaults.

¹² Moreover, any interconnectedness that results from the mutualization of losses in the central clearing model is substantially curtailed by a waterfall of risk mitigants that include robust amounts of initial margin, pre-funded default fund contributions, CCP capital, and other safeguards. *See, e.g.*, 17 C.F.R. § 39.13(g)(2)(iii) (requiring CCPs to establish initial margin requirements sufficient to cover their potential future exposures to clearing members over a specified liquidation time with an established confidence level of 99 percent). This waterfall structure greatly reduces the probability that other clearing members would suffer losses due to a clearing member’s default, as well as the potential impact of any such losses. A CCP can endure “truly extreme” losses without clearing members being required to make additional contributions to the CCP. *See* CME Group, *Balancing CCP and Member Contributions with* (continued...)

Central clearing also reduces systemic risk by facilitating the transfer (or “port”) of the positions (and collateral) of a defaulting clearing member’s clients to other, financially sound clearing members in a simple and rapid manner, with the goal of preserving the end-users’ positions while protecting any collateral pledged. Porting reduces clients’ exposure to counterparty default losses, which strengthens the resilience of the banking system by:

- discouraging counterparties from participating in destabilizing runs on banks;
- reducing the cascade of defaults that can result from clients incurring losses or going unhedged; and
- limiting losses to banks that are themselves clients of the affected clearing member.

In short, as Board Chair Powell has summarized, “[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.”¹³

C. Client clearing is fundamentally a low-risk activity for the clearing member

Not only does client clearing reduce systemic risk in the aggregate, it also does not create outsized risks for clearing members. Under the agency model of clearing that is prevalent in the United States, a banking organization acts as agent for its client, which enters into the OTC derivative transaction 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.

Several features of client clearing reduce the risks that clearing members face. First, on a daily or twice-daily basis, the client is either required to post variation margin in the form of cash to secure the full amount that it is out of the money on the derivative on a mark-to-market basis (in a CTM trade) or is required to provide an equivalent cash payment to settle the derivative (in an STM trade). In this way, variation margin or settlement payments eliminate the clearing member’s actual current exposure to the client at the time the variation margin is posted or payment is made. Because of the daily or twice-daily posting of margin or exchange of settlement payments, the clearing member remains exposed only to the possibility that market values will move in excess of the client’s posted margin during the one day or half a day since

Exposures, at p. 4 (Aug. 18, 2017), *available at* <http://www.cmegroup.com/education/balancing-ccp-and-member-contributions-with-exposures.html>.

¹³ 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>.

the last posting of variation margin or exchange of settlement payments, and the client fails to post that incremental value.

Second, the client is also required to post initial margin in the form of cash or highly liquid securities to secure the clearing member's exposure to movement in market prices. The amount of initial margin the client will be required to post depends on the volatility of the derivative. Clients generally post initial margin in excess of the expected change in value of the client's position, which for cleared swaps must be calculated with a 99 percent confidence interval over a close-out period of at least five days.¹⁴ Clearing members also often have a contractual right to call additional initial margin. In this way, initial margin reduces the clearing member's actual potential future exposure.

Third, while clearing members do agree to mutualize losses that would arise from the default of a clearing member, they pre-fund such loss mutualization with default fund contributions. CCPs' own capital and other safeguards further limit losses that clearing members could be forced to incur. The mutualization of losses would only be required if the defaulter's initial margin, clearing members' aggregate default fund contributions, and CCP capital prove insufficient.

In sum, a clearing member is well-protected against the risk that its client would default on its obligation to the CCP without having posted sufficient margin to cover the client's payment obligation, requiring the clearing member to perform on its guarantee to the CCP. As described in the following section, this residual risk is already adequately capitalized in the existing regulatory capital framework.

D. The U.S. capital rules already impose disproportionately high capital requirements on banking organizations' clearing activities

The U.S. capital rules currently impose many overlapping layers of capital requirements relating to derivatives clearing activities. These requirements include:

- Risk-based capital requirements for, among other things:¹⁵
 - counterparty credit risk requirements, currently in the form of SA-CCR for large banks; and
 - CCP default fund contributions.

¹⁴ See 17 C.F.R. § 39.13(g)(2).

¹⁵ The existing capital rules also include potential capital charges for derivatives clearing within the advanced approaches framework through CVA risk and operational risk. However, as discussed below, the advanced approaches framework is not binding for most clearing members, and as a result, banking organizations generally currently do not manage their balance sheets with a view to these requirements.

- Leverage capital requirements for counterparty credit risk and the on-balance sheet portion of margin;
- G-SIB Surcharge capital requirements, which already capture certain derivatives clearing activities within multiple categories; and
- Stress capital buffer requirements that result from the treatment of derivatives clearing activities within stress test scenarios.

Due to these overlapping and significant capital requirements, large banking organizations already maintain substantial capital levels to support their clearing businesses. A quantitative impact study of six U.S. G-SIBs that are significant clearing members in the United States, using data as of June 30, 2023, indicates that the U.S. standardized approach currently requires these six firms to maintain over \$8.96 billion in capital solely to engage in client clearing activities.¹⁶ These levels of capitalization are already outsized to the modest risks that derivatives clearing activity poses to clearing members, even before taking into account the changes in the Proposals.¹⁷

E. Disproportionately high capital requirements cause banking organizations to reduce their clearing activity, which increases systemic risk

Because the capital rules impose excessive capital requirements on derivatives clearing businesses, two consequences are resulting.

First, some clearing businesses within banks are becoming unable to meet ROE targets without raising prices, perhaps beyond the point where clients will find it economical to use cleared derivatives to hedge their risks. Clients may respond by going unhedged, which could increase risk in the financial system.¹⁸ And to the extent that clients pay higher prices and do hedge, they will have fewer resources available to invest in their businesses, and/or will pass the costs to their own clients and consumers.

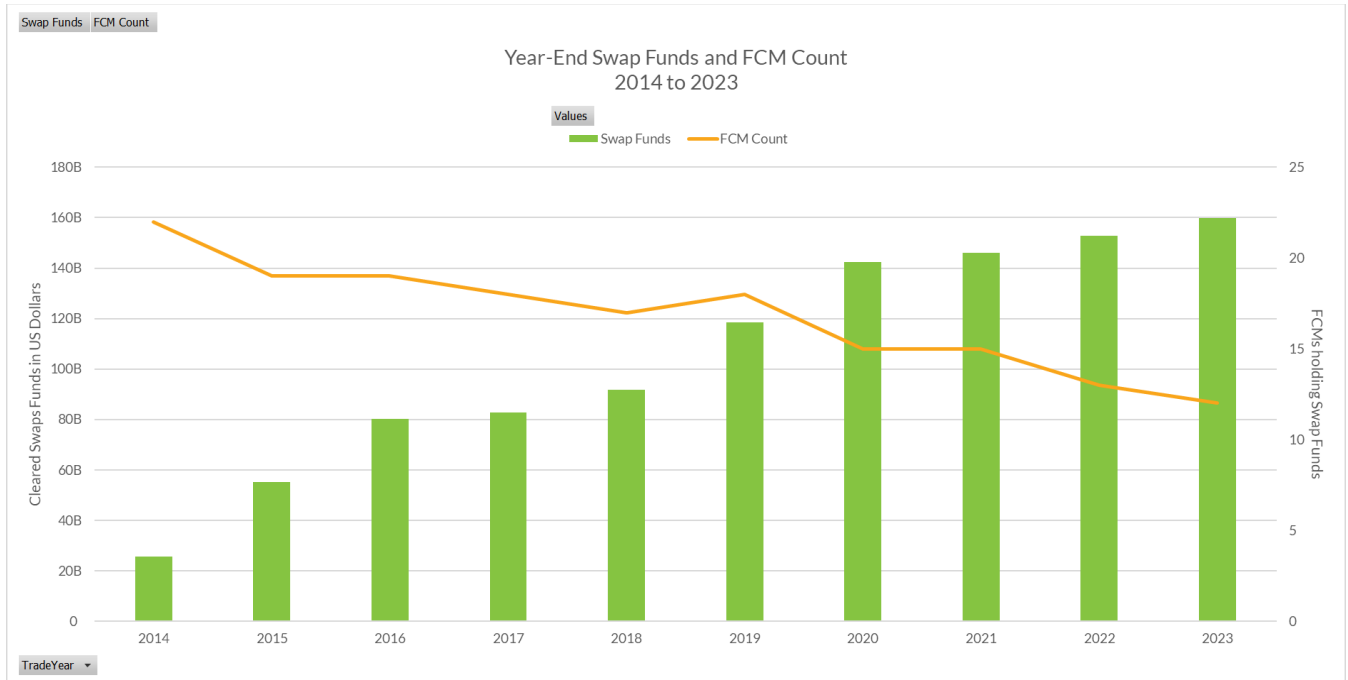
¹⁶ We calculated this figure by multiplying the six firms' risk-weighted assets attributed to client clearing activities in the current U.S. standardized approach by these firms' capital requirements, which are comprised of the minimum capital requirement, stress capital buffer requirement, and G-SIB Surcharge capital requirement. Except where indicated elsewhere in this letter, our impact assessment is based on data reported in the quantitative impact study.

¹⁷ For instance, the SA-CCR framework does not fully take into account the risk-reducing effect of initial margin. See Michael Roberson, CFTC Risk Analyst, *An Empirical Analysis of Initial Margin and the SA-CCR (2018)*, available at <https://www.cftc.gov/sites/default/files/2018-07/SA-CCRPaper0718.pdf>.

¹⁸ Moreover, it is not realistic to expect that clients would ever become direct members of a CCP, as the vast majority of clients are not financial institutions and thus are not equipped to manage the risks of being a clearing member, contribute to a CCP's default fund, or comply with all the rules and requirements that apply to clearing members.

Second, some banks are becoming disincentivized from offering clearing services altogether, except possibly as a limited accommodation to clients of other business lines. This risk is not merely theoretical. When Dodd-Frank Act reforms became effective in 2014, there were 22 futures commission merchants (“FCMs”) providing OTC clearing in the United States.¹⁹ Today, there are 12 clearing firms, with 7 of these firms comprising 94 percent of the market, as shown in Figures 3 and 4 below:²⁰

Figure 3: Comparison of Customer Funds in Swap Accounts and Number of FCMs²¹

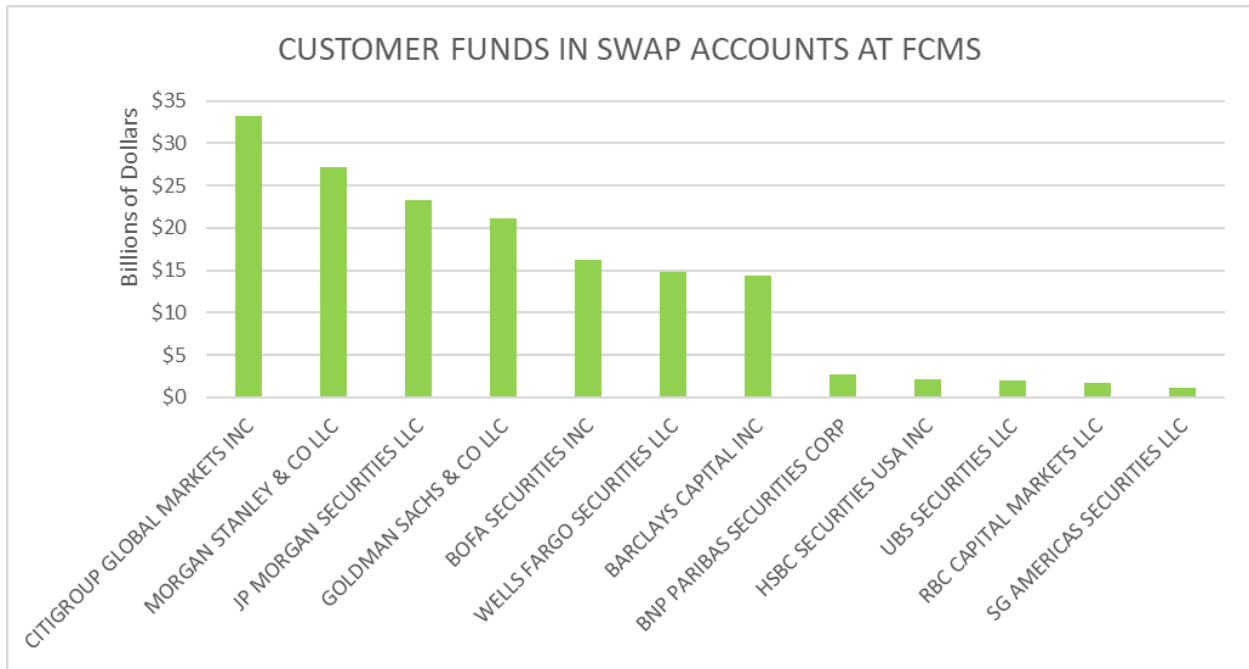


¹⁹ See Commodity Futures Trading Commission, Financial Data for FCMs, available at <https://www.cftc.gov/MarketReports/financialfcmdata/index.htm>.

²⁰ See *id.*

²¹ Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

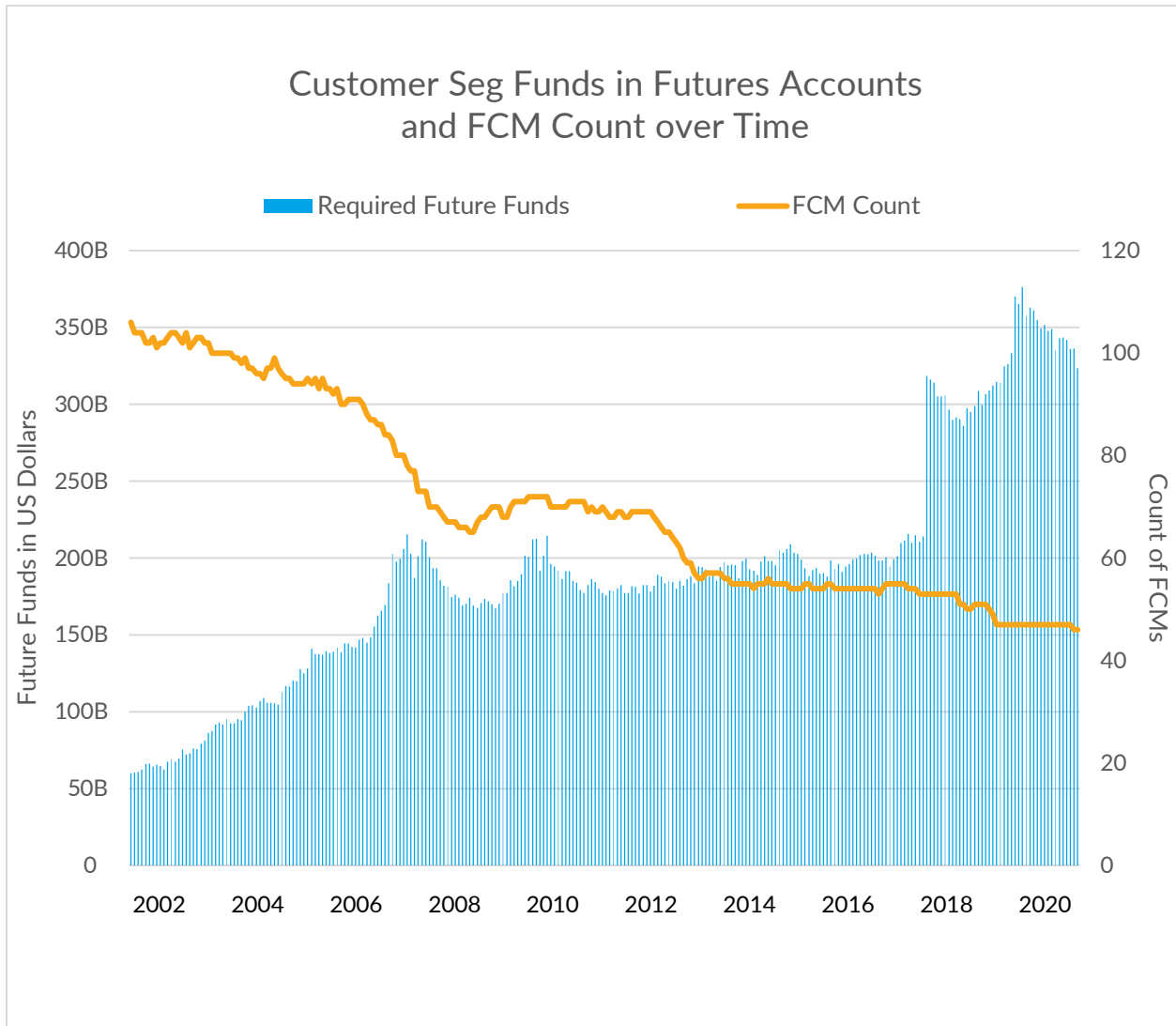
Figure 4: Share of the Swaps Clearing Business²²



²² Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

A similar dynamic has occurred in futures clearing, as shown in Figures 5 and 6, below:

Figure 5: Comparison of Customer Funds in Futures Accounts and Number of FCMs²³



²³ Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

Figure 6: Share of the Futures Clearing Business²⁴

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

The bulk of the market exits from the clearing business occurred during a period when a specific capital requirement – the Supplementary Leverage Ratio – imposed a disproportionately high capital charge on derivatives clearing activities.²⁵ These market exits are all the more notable given that over the same timeframe, policymakers implemented clearing mandates globally that have increased the aggregate volume of clearing, as exemplified in Figure 3, above.

A reduction in the number of firms willing to serve as clearing members – and to increase their volume of clearing activity, if needed – could increase systemic risk. Porting depends on the presence of a number of clearing members with capacity and willingness to take on additional clients from a failing clearing member in a rapid manner. The Derivatives Assessment Team of the Financial Stability Board and other international standard-setting bodies

²⁴ Source: FIA FCM Tracker, based on CFTC Data Published as of July 2023, available at <https://www.fia.org/articles/fcm-tracker>.

²⁵ DAT Report at pp. 20-21.

(“DAT”) has warned that if capital requirements for clearing are disproportionately high, “other providers may be unwilling to take on additional business, leaving some of the affected clients without access to OTC derivatives clearing.”²⁶

Reductions in clearing member capacity “could amplify the consequences of the failure or withdrawal of a major provider” because there are fewer remaining clearing members that might be available and willing to step in and accept a book of cleared derivatives.²⁷ These issues will be exacerbated in times of market stress.²⁸ As the DAT explained, “a clearing service provider must have sufficient ‘head room’ in its regulatory metrics before accepting [clients that wish to port in], and additional client clearing business must offer an acceptable return on the required capital thus deployed.”²⁹ Ad hoc capital relief provided by supervisors once the stress materialized would be insufficient to mitigate the risk of accepting business generating negative post-capital returns over the life of the trade. And ad hoc relief would also be insufficient because porting is only effective when it occurs rapidly.³⁰

II. The Federal Banking Agencies Should Make Changes to the Proposed Regulatory Capital Treatment of Central Clearing of Derivatives to Ensure That Regulatory Capital Rules Do Not Disincentivize Such Activity, Harming End Users and Increasing Systemic Risk

We have serious concerns that the Endgame Proposal’s regulatory capital treatment of derivatives clearing activities would impose disproportionately high capital requirements on clearing, disincentivizing banking organizations from engaging in those activities, which, as described above, would reduce end users’ access to derivatives, increase end users’ costs for accessing derivatives to hedge their risks, and impede porting of derivatives in times of market stress.

A quantitative impact study of six U.S. G-SIBs that offer client clearing services indicates that the Endgame Proposal’s expanded risk-based approach would significantly increase capital requirements for client clearing of derivatives. As noted above, the current U.S. standardized approach requires these six firms to maintain over \$8.96 billion in capital solely to engage in client clearing activities. The proposed expanded risk-based approach would increase

²⁶ DAT Report at p. 54.

²⁷ DAT Report at p. 3.

²⁸ Clearing members absorbed Credit Suisse’s U.S. cleared derivatives client portfolio after that firm announced its exit from the U.S. market for clearing in November 2021. However, this exit may not be predictive of whether clearing members will have the capacity to port in a defaulting clearing member’s business rapidly during times of stress if the Proposals are finalized as proposed and clearing members would incur a more significant capital penalty for absorbing others’ client positions.

²⁹ DAT Report at p. 67.

³⁰ Besides porting, there are additional benefits to ensuring that clearing members have adequate capacity to take on new business. When there is capacity in the market, clients can diversify the number of providers they use, and market participants can choose to clear additional products that are not currently subject to a clearing mandate.

the capital required for these six firms to engage in their current scope of client clearing activities by more than **22 percent**, or over **\$2.01 billion** in the aggregate.³¹ Most of this increase would be driven by the proposed operational risk framework's treatment of client clearing activity, while a significant portion would be driven by the inclusion of client clearing activity in the CVA framework.³²

Our concerns are compounded by the fact that the Surcharge Proposal would likewise raise capital requirements for clearing activities. The Surcharge Proposal would increase capital requirements attributable to the six firms' client clearing activities by more than **58 percent**, or over **\$5.20 billion** in the aggregate.³³ **Collectively, the two Proposals would increase the six firms' capital requirements for client clearing activities by more than 80 percent, or over \$7.21 billion in the aggregate.**

³¹ Our calculation of the pro forma capital impact of the Endgame Proposal reflects the higher risk-weighted assets required for client clearing under the expanded risk-based approach compared to the current U.S. standardized approach, as well as proposed increases in firms' minimum capital requirements arising from the Proposals' changes to the stress capital buffer and certain changes to the G-SIB Surcharge. Specifically, our calculation assumes an increase in firms' capital requirements of 10 basis points due to changes in the firmwide G-SIB Surcharge requirement, reflecting the Board's estimated increase of 11 Method 2 score points due to the inclusion of derivative exposures in Cross-Jurisdictional Activity indicators, and the Board's estimated increase of 9 Method 2 score points due to the effect of averaging the indicators. See 88 Fed. Reg. at 60,397. To avoid a double-count when we present the cumulative impact of the Proposals, our calculation of the impact of the Endgame Proposal excludes proposed changes to the G-SIB Surcharge that would directly impact client clearing, such as including client OTC derivatives cleared under the agency model in the Complexity and Interconnectedness indicators.

³² Of the more than 22 percent total increase in capital requirements for client clearing activities, 79 percent would be attributed to the operational risk framework, and 36 percent would be attributed to the CVA framework. These numbers do not sum to 100 percent because the Endgame Proposal would make other changes to the counterparty credit risk framework that would decrease risk-weighted assets compared to the current U.S. standardized approach.

³³ We calculated the Surcharge Proposal's capital impact of \$5.20 billion by reflecting the changes to the six participating firms' Method 2 G-SIB Surcharge scores arising from the Surcharge Proposal's changes to the treatment of client clearing activities. Specifically, the net increase takes account of the increases to these firms' Method 2 scores arising from the proposed inclusion of client OTC clearing under the agency model to the Complexity and Interconnectedness indicators as well as a modest decrease to Method 2 scores attributable to client clearing activities arising from the incorporation of SA-CCR into the Interconnectedness indicator. For purposes of calculating the impact of changes to the Interconnectedness score, participating firms assumed that the alpha factor in the version of SA-CCR used in Interconnectedness indicator would be 1.0, which is consistent with industry recommendations but provides more conservative (lower) projected impact than if the Board decided to apply an alpha factor of 1.4, as proposed. We translated this Method 2 score increase into a G-SIB Surcharge capital requirement increase by dividing the score increase by 20 and multiplying by 10 basis points (which is the size of the increase in capital requirement for each 20 point increase in Method 2 score). We then multiplied this projected increase in capital requirement by the total risk-weighted assets for the (continued...)

The agencies should therefore make the changes described below, as well as the changes to the Surcharge Proposal that we recommend in our separate letter addressing that rulemaking, to ensure that various elements of the regulatory capital framework – either in isolation or through their cumulative impact – do not have those negative effects.

A. Exclude exposures arising from client clearing of derivatives from the CVA framework

Client cleared derivatives should be removed from the scope of the CVA framework set forth in the Endgame Proposal. The only counterparty credit risk-related losses that a clearing member can incur in client clearing is when there is an actual default of the client and losses incurred on liquidating the client portfolio exceed the client initial margin held by the clearing member. This loss exposure is already captured through the existing counterparty credit risk default charge within SA-CCR. Moreover, the initial margin that clearing members collect from clients is generally adequate to mitigate the gap risk as a result of a client default.

Clearing members do not account for client clearing transactions on their balance sheets when acting as an agent or in a riskless principal capacity. Clearing members merely facilitate the clearing of trades for their clients. Any principal risk is borne directly by the client, not the clearing member. Given that client cleared transactions are off balance sheet, clearing members also do not record CVA against these transactions under U.S. GAAP, nor could they record a CVA loss under U.S. GAAP. In this respect, it is unclear what risk the CVA framework would be intended to capitalize in the case of a client cleared transaction.

While we understand that the agencies have previously considered this issue,³⁴ changes in circumstances warrant a reevaluation of the issue as part of the present rulemaking, for several reasons:

- **First**, whereas the CVA framework currently applies only under the advanced approach, which generally is *not* the binding constraint for large banks that are clearing members,³⁵ the Endgame Proposal would include CVA in the expanded risk-based approach that likely *would* become the binding constraint for most large banks.³⁶ Many firms make capital allocation decisions based solely on those capital requirements that serve as their

participating firms, calculated under the Endgame Proposal’s expanded risk-based approach, to arrive at the aggregate capital impact for the six firms.

³⁴ See 77 Fed. Reg. 52,978, 52,984 (Aug. 30, 2012).

³⁵ Recent public filings by the holding companies of the six largest U.S. clearing members of swaps – Bank of America, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, and Wells Fargo – indicate that most of them have higher risk-weighted assets under the standardized approach than the advanced approach, and all of them have higher risk-based capital requirements under the standardized approach when considering that the stress capital buffer is only incorporated into standardized approach capital requirements. Thus, the standardized approach is the binding constraint for these clearing members.

³⁶ 88 Fed. Reg. at 64,168 (“The overall increase would lead to the expanded risk-based framework becoming the binding risk-based approach for most large banking organizations.”).

binding constraint. Thus, the proposed inclusion of client clearing activity in the CVA framework within the expanded risk-based approach could create an incentive for banking organizations to reduce their clearing activity or raise prices in a way that the existing inclusion of this activity in the CVA framework within the advanced approach rule does not currently do.

- **Second**, the Endgame Proposal states that cleared transactions and securities-financing transactions would not be CVA risk covered positions (and thus not subject to a CVA capital charge) because a banking organization generally does not calculate CVA for those transactions for financial reporting purposes.³⁷ By the same reasoning, client clearing of derivatives should not be CVA risk covered positions (and not subject to a CVA capital charge), because banking organizations do not calculate CVA for these transactions for financial reporting purposes.
- **Third**, other jurisdictions, most notably the European Union³⁸ and the UK,³⁹ have excluded or proposed to exclude most client cleared transactions from their CVA frameworks. Even the Basel Committee’s CVA standard contains exceptions for certain cleared derivatives.⁴⁰ The federal banking agencies should align with the approach taken by their global peers to create competitive equity and a harmonized approach.
- **Finally**, the continued inclusion of client cleared transactions in the CVA framework would have a significant negative impact on client clearing. Our members’ quantitative impact study shows that the risk-weighted assets attributed to the six participating U.S G-SIBs’ client clearing activities would increase by 12.1 percent due to the proposed inclusion of the CVA framework in the expanded risk-based approach and the continued

³⁷ 88 Fed. Reg. at 64,151.

³⁸ See EU Capital Requirements Regulation (CRR), Art. 382(3), *available at* <https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/1568> (“Transactions with a qualifying central counterparty and a client’s transactions with a clearing member, when the clearing member is acting as an intermediary between the client and a qualifying central counterparty and the transactions give rise to a trade exposure of the clearing member to the qualifying central counterparty, are excluded from the own funds requirements for CVA risk”); European Banking Authority Q&A No. 2016_3009 (Jan. 20, 2017), *available at* https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2016_3009 (clarifying that “centrally cleared clients’ trades should be exempted from both the perspective of the clearing member and the client”). Notably, European capital requirements also exempt most trades with non-financial counterparties such as corporates and pension funds.

³⁹ Bank of England, Prudential Regulation Authority, Near-final Part 1 Policy Statement 17/23 – Implementation of the Basel 3.1 standards: Credit valuation adjustment and counterparty credit risk, § 4.9, 4.10 and 4.13 (Dec. 23, 2023), *available at* <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2023/december/ps1723-full.pdf>.

⁴⁰ See Basel Committee on Banking Supervision, Targeted Revisions to the Credit Valuation Framework, Para. 50.5 (July 2020) (“Covered transactions include: (1) all derivatives except those transacted directly with a qualified central counterparty and except those transactions meeting the conditions of [CRE54.14] to [CRE54.16]”).

inclusion of client clearing activities in the CVA framework, compared to the total amount of risk-weighted assets attributed to client clearing activities under the standardized approach.⁴¹ That increase is before even taking into account other features of the Proposals such as including such transactions in the Complexity and Interconnectedness indicators of the G-SIB Surcharge. The agencies should consider such cumulative impact when evaluating the scope of the CVA framework.

For all of these reasons, the agencies should remove client cleared derivatives from the scope of the CVA framework in the final rules implementing the Endgame Proposal.

B. Revise the Endgame Proposal’s approach to calculating the services component of operational risk

Under the Endgame Proposal, operational risk for fee services businesses like derivatives clearing would be calculated as a function of revenues or expenses, calculated on a gross basis. This methodology would impose significant operational risk capital requirements for derivatives clearing activities. Our members’ quantitative impact study of six U.S. G-SIBs that are significant clearing members indicates that operational risk charges would be responsible for 20 percent of the total risk-weighted assets attributable to client clearing activities under the proposed expanded risk-based approach.

Calculating operational risk capital requirements on a gross basis would disproportionately impact derivatives clearing for two reasons:

- **First**, clearing members pass CCP and exchange fees through to clients, and then remit those fees back to CCPs and exchanges. Some clearing members account for these fees as their own revenues and expenses. As a result, many clearing members have artificially high gross revenues – gross revenues that can be multiples of the net revenues that clearing members retain. But this practice does not mean that the clearing business is any more complex or prone to operational losses.
- **Second**, the derivatives clearing business is subject to significant capital charges elsewhere in the capital rules, including the counterparty credit risk framework.

The agencies should revise the formula for the services component of the business indicator to allow for the netting of revenues and expense, and to make other changes endorsed in FIA’s separate letter on the operational risk framework, submitted jointly with the Securities Industry and Financial Markets Association.

⁴¹ We calculated this 12.1 percent increase by dividing the risk-weighted assets that the six firms participating in the quantitative impact study project would derive from client clearing activities under the proposed CVA framework by the total risk-weighted assets that these firms attribute to client clearing activities under the current standardized approach.

C. Revise SA-CCR to permit netting of STM and CTM transactions against each other even when they are not “cleared transactions,” a term that the capital rules define to exclude client clearing

The Endgame Proposal would revise the definition of “netting set” to provide that a netting set must be composed solely of a single product (*e.g.*, all derivative contracts, but not derivative contracts and repo-style transactions). In connection with this revision, the agencies should permit a broader range of netting within single products – specifically, to permit netting across STM and CTM derivatives.

The capital rules generally permit a banking organization to calculate its exposures across multiple derivatives contracts with a single counterparty on a net basis when certain conditions are satisfied. This treatment reflects the economic reality that insolvency law generally permits a counterparty to a derivative contract with an insolvent company to offset the balance the counterparty owes to the insolvent company by the balance the insolvent company owes the counterparty. While this basic principle of insolvency law extends to, and permits, the netting of obligations from a STM transaction against obligations from a CTM transaction with the same counterparty and vice versa, the existing capital rules only allow for calculating STM and CTM exposures on a net basis only when they are “cleared transactions.”

The general rule in SA-CCR is that a banking organization cannot net margined and unmargined trades within the same legal netting set for purposes of calculating potential future exposure (“PFE”). The preamble to the final SA-CCR rule noted that where the positions are settled daily (*i.e.*, STM transactions), these should be considered as unmargined derivative contracts. Where the position is collateralized (*i.e.*, CTM transactions), these should be considered margined derivatives contracts. For this reason, if a netting set has both STM and CTM trades, two separate subsets are created for PFE calculation purposes, even if the transactions are subject to the same legally enforceable netting agreement.

The final SA-CCR rule addressed this issue for “cleared transactions” by permitting a banking organization to treat an STM trade that is a “cleared transaction” as if it were a CTM trade for purposes of calculating PFE.⁴² The agencies stated that they permitted such netting in the final SA-CCR rule in response to commenters that encouraged the netting across STM and CTM transactions that a banking organization has cleared for its clients.⁴³ However, the term that the agencies used the rule text to describe the transactions that can be netted in this manner – “cleared transactions” – captures only CCP-facing exposures and excludes exposures resulting from a clearing member’s guarantee of its client’s obligation to the CCP. The comment letters

⁴² 85 Fed. Reg. 4,362, 4,365 (Jan. 24, 2020).

⁴³ *Id.* (preamble to final SA-CCR rule stating that “Commenters also raised concerns regarding the proposed netting treatment for settled-to-market derivative contracts. The final rule allows a banking organization to elect, at the netting set level, to treat all such contracts within the same netting set as collateralized-to-market, thus allowing netting of settled-to-market derivative contracts with collateralized-to-market derivative contracts within the same netting set.”). These commenters included FIA. *See* FIA Letter on Netting of STM and CTM Trades under the SA-CCR Rule (Jan. 24, 2020).

that the agencies stated they intended this change to address covered these client-facing exposures.⁴⁴

The final SA-CCR rule preamble does not suggest that the agencies had any reason to limit the availability of netting across STM and CTM transactions to cleared transactions, and there is no conceptual reason to impose such limitations. Limiting this treatment to cleared transactions is particularly problematic for banking organizations that clear exchange-traded derivatives, as options on futures may be STM (if they are options with “futures-style” margining, with no upfront premiums but daily variation margin) or may be CTM (if they are options with “equity-style” margining, which means they have upfront premiums but no daily variation margin). A clearing member’s inability to net exposures across these transactions creates a disconnect between the regulatory capital rules, on the one hand, and underlying risk and legal frameworks under which the clearing member manages the transactions, on the other hand. In the event of a close-out scenario, all STM and CTM transactions under the same Qualified Master Netting Agreement would be closed out on a net basis.

The agencies should use the Endgame Proposal rulemaking to remediate this issue and permit the netting of STM and CTM transactions that arise when a banking organization, acting as clearing member, guarantees its client’s performance to the CCP, in SA-CCR’s calculation of PFE. The agencies could achieve this result by permitting banking organizations to elect to treat STM transactions as CTM transactions for purposes of calculating PFE in SA-CCR. Our members’ quantitative impact study of U.S. G-SIBs that are significant clearing members indicates that the ability to net STM and CTM transactions, while increasing risk-sensitivity, would decrease these firms’ risk-weighted assets attributable to client clearing under the expanded risk-based approach by 3 percent.⁴⁵

D. Withdraw the Endgame Proposal’s changes that would prohibit the decomposition of nonlinear instruments on indices within SA-CCR

The Endgame Proposal would prohibit banking organizations from decomposing nonlinear instruments on indices when calculating the exposures associated with the clearing or trading of indexed products, such as equity options based on an index. According to the agencies, this prohibition is due to the fact that “it is not mathematically possible to calculate the supervisory delta for an underlying component, as the delta associated with the non-linear index applies at the instrument level.”⁴⁶ Rather than prohibit decomposition, however, the agencies should permit banking organizations to decompose options on indices by allowing banks to calculate the supervisory delta at the index level and apply this delta value to each single name security within the index. While we acknowledge that this approach is a simplification compared to a marginal calculation, any discrepancy would be very small in the context of cleared plain vanilla options on diversified indices. Decomposition enhances risk sensitivity and should be available to both linear and non-linear derivatives on indices. This is particularly

⁴⁴ See FIA Letter on Netting of STM and CTM Trades under the SA-CCR Rule (Jan. 24, 2020).

⁴⁵ Five members provided this data.

⁴⁶ 88 Fed. Reg. at 64,058.

relevant in the context of market-making activity that generally results in balanced long / short portfolios.

Our members' quantitative impact study of U.S. G-SIBs that are significant clearing members indicates that the ability to decompose non-linear instrument on indices would decrease these firms' risk-weighted assets attributable to client clearing under the expanded risk-based approach by 3 percent compared to the expanded risk-based approach as it has been proposed.⁴⁷

E. Omit the Endgame Proposal's requirement for an investment grade obligor to be publicly traded to be eligible for a lower risk weight

The Endgame Proposal would make a corporate counterparty obligor eligible for the lower risk weight of 65 percent when the obligor is "investment grade" and has a class of publicly traded security outstanding (or is controlled by a company that does). While the requirement for the obligor to be publicly traded to be eligible for this lower risk weight would have general application across several banking business lines, it would have a disproportionately negative impact on the derivatives clearing business and for specific categories of customers that use derivatives to hedge their risks and are highly creditworthy but are not publicly traded.

Given the nature of the clearing business, a substantial portion of a clearing member's derivatives customer base is not publicly traded despite being highly creditworthy, including pension funds, insurance companies, agriculture businesses, and companies that are owned by sovereign entities.⁴⁸

Accordingly, the failure to make non-publicly traded investment grade obligors eligible for the 65 percent risk weight would make risk-weighted assets from client clearing activities artificially high. Moreover, the requirement to be publicly traded will have negative impacts on these customers themselves. If these customers' derivative transactions carry higher capital charges than other customers' transactions, they may face higher prices from banking organizations seeking to alleviate the cost pressure that the Endgame Proposal would create.

The agencies should altogether omit the requirement to be publicly traded from the eligibility criteria for the 65 percent risk weight. Our members' quantitative impact study of six U.S. G-SIBs that are significant clearing members indicates that their risk-weighted assets from client clearing activities under the expanded risk-based approach would be 6.1 percent lower if

⁴⁷ Four members provided this data.

⁴⁸ For a typical clearing member, virtually none of its OTC derivatives clearing customers would qualify for the lower risk weight available to retail exposures. The proposed definition of retail exposure includes (1) natural persons and (2) only for revolving credit, a line of credit, or a term loan or lease, a small or medium-sized entity. *See* 88 Fed. Reg. 64,186. The typical clearing member does not clear OTC derivatives transactions for natural persons, and derivatives contracts are not revolving credit, lines of credit, or loans or leases.

the publicly-traded requirement were removed in the final rule, compared to the expanded-risk based approach with the publicly-traded requirement.

Should the agencies not remove the publicly-traded requirement from the final rule, they should at least permit a banking organization to assign an investment grade counterparty the 65 percent risk weight when the counterparty is (1) a regulated financial entity, such as an investment advisor, registered investment fund, pension fund, insurance company, or foreign equivalent of the foregoing types of entities, or (2) has provided the banking entity with audited and interim financial statements akin to the financial information reported by publicly traded companies.

F. Maintain the current standardized approach’s minimum risk weight of 20 percent for exposures to depository institutions and foreign banks and adopt the Basel Committee’s framework for short-term exposures to banks

The Endgame Proposal’s expanded risk-based approach would establish risk weights of 40 percent, 75 percent, or 150 percent for exposures to depository institutions and foreign banks, as compared to the current standardized approach’s risk weights of 20 percent or 50 percent for exposures to most such institutions. In other words, the minimum risk weight for a depository institution or foreign bank would double from 20 percent to 40 percent, which is notable because most depository institutions and foreign banks to which large U.S. banking organizations are exposed are eligible for the lowest risk weighting.

While this change, too, would have general application across banking organizations’ business lines, it would have a particularly acute impact on derivatives clearing businesses for two reasons. First, some banking organizations clear derivatives through foreign banks to help their clients access non-U.S. CCPs, and this transaction structure could result in the banking organization recognizing an exposure to the foreign bank. This transaction structure is relatively common for the U.S. operations of foreign banking organizations. For example, if a subsidiary of a foreign banking organization’s U.S. intermediate holding company (“IHC”) clears a derivative transaction outside the United States for a U.S. client, the IHC may do so by using an affiliated foreign bank as a clearing member, and guarantee that affiliate’s performance to the client, which creates an exposure to the foreign bank for the IHC. The inverse also occurs. If a U.S. clearing member’s client is a depository institution or foreign bank, the clearing member will have an exposure to the depository institution or foreign bank by virtue of its guarantee of the client’s performance to the CCP.

Second, some clearing members maintain bank accounts at a depository institution or foreign bank where they might deposit excess margin. This transaction structure is relatively common for clearing members that provide clearing services outside the United States. As a result, the doubling of the minimum risk weight for exposures to depository institutions and foreign banks could make it more costly for banks to offer clearing services on a cross-border basis, and could disincentivize banks from taking margin in the form of cash.

We therefore recommend that any final rules adopt the current standardized approach's minimum risk weight of 20 percent for depository institutions and foreign banks, rather than the significantly higher minimum risk weight of 40 percent set forth in the Endgame Proposal.

The agencies should also adopt the Basel Committee's framework to provide lower minimum risk weights for short-term exposures to banks. However, such a revision would not fully address the problem for derivatives clearing businesses, as many cleared derivatives transactions, especially CTM transactions, have a minimum maturity date of more than three months, and thus would not be eligible for treatment as a short-term exposure.

III. Conclusion

We urge the agencies to make the changes described above when finalizing the Endgame Proposal. These changes are particularly important given that the Board has separately proposed to increase the capital required for OTC derivatives through the Surcharge Proposal, which, in combination with the Endgame Proposal, could have significant negative impacts that are specific to this critical market service and the participants that rely on it. Absent the changes we propose above, we believe the capital treatment of derivatives clearing would be unnecessarily conservative, to the detriment of end users and the portability of cleared derivatives.

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We look forward to engaging with the agencies on the matters discussed in this letter. If you have any questions, please contact Jacqueline Mesa, Chief Operating Officer and Senior Vice President of Global Policy at FIA at 202-466-5460.

Respectfully Submitted,



Walt L. Lukken
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Appendix – Answers to Questions in Endgame Proposal Preamble

Question 38: What, if any, alternative criteria should the agencies consider to identify corporate exposures that would warrant a risk weight of 65 percent or a risk weight between 65 percent and 100 percent?

The agencies should omit the “publicly-traded” criterion for an obligor to be eligible for the 65 percent risk weight. See section II.E above for a more detailed discussion of this issue.

Question 74: What are the advantages and disadvantages of the proposed approach to calculating the services component, including any impacts on specific business models? Which alternatives, if any, should the agencies consider and why? Similarly, should the agencies consider any adjustments or limits related to specific business lines, such as underwriting, wealth management, or custody, or to specific fee types, such as interchange fees, and if so what adjustment or limits should they consider? For example, should the agencies consider adjusting or limiting how the services component contributes to the business indicator and, if so, how? What would be the advantages and disadvantages of any alternative approach and what impact would such an alternative approach have on operational risk capital requirements? For example, under the proposal, fee income and expenses of charge cards are included under the services component. Would it be more appropriate for fee income and expenses of charge cards to be included in net interest income of the interest, lease, and dividend component (and excluded from the services component) and for charge card exposures to be included in interest earning assets of the interest, lease, and dividend component and why? Please provide supporting data with your response.

The proposed approach to calculating the services component would have a negative effect on business lines engaged in client clearing of derivatives, and the clients seeking clearing services to access derivatives to hedge their risks. See section II.B above for a discussion of these impacts, supporting data, and an alternative approach.